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No. _____

In the
Supreme Court of the United States
October Term, 1993

ROBERT E. MEUNIER, EARL W. MILLER, and EDWARD GARIN,

Petitioners,

v.

MINNESOTA DEPARTMENT OF REVENUE, and DOROTHY A. McCLUNG, in her capacity as Minnesota Commissioner of Revenue,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE MINNESOTA SUPREME COURT

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

Does the constitutionally mandated exemption from state income taxation of 31 U.S.C. § 3124(a) apply to the federal interest portion of retirees' distribution from the Civil Service Retirement and Disability Fund?

Does state income taxation of the federal interest portion of distributions from the Civil Service Retirement and Disability Fund violate the constitutional doctrine of intergovernmental tax immunity and 4 U.S.C. § 111 where the federal interest portion of distributions from private retirement plans is not taxable?

LIST OF PARTIES

The parties to Meunier v. Minnesota Department of Revenue are Robert E. Meunier, Earl W. Miller and Edward Garin, Petitioners, and Minnesota Department of Revenue and Dorothy A. McClung, Respondents.

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IN THE
SUPREME COURT OF THE UNITED STATES
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ROBERT E. MEUNIER, EARL W. MILLER,
and EDWARD GARIN,

Petitioners,

vs.

MINNESOTA DEPARTMENT OF REVENUE,
and DOROTHY A. McCLUNG, in her
capacity as Minnesota Commissioner
of Revenue,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE MINNESOTA SUPREME COURT

Petitioners respectfully pray that a writ of certiorari issue to review the judgment and opinion of the Minnesota Supreme Court dated July 23, 1993.

OPINION BELOW

The opinion of the Minnesota Supreme Court in Meunier, et al v. Minnesota Department of Revenue, et al, No. C4-92-1626 (Minn. July 23, 1993) is printed in the Appendix ("App.") at A-1. Also included in the Appendix is the unpublished opinion of the District Court of Hennepin County, Minnesota, printed at App. B-1 and the Stipulation of Facts on which both decisions are based, printed at App. C-1.

JURISDICTION

The opinion of the Minnesota Supreme Court in Meunier v. Minnesota Department of Revenue was rendered on July 23, 1993. No motion for rehearing was filed. Jurisdiction in this Court is vested by 28 U.S.C. § 1257(3).

CONSTITUTIONAL PROVISIONS AND STATUTES

U. S. Const. Art. I, § 8 Cl. 2:

The Congress shall have power...to borrow money on the credit of the United States;

U.S. Const. Art. VI, Cl. 2:

This Constitution, and the laws of the United States, which shall be made in pursuance thereof; and all treaties made, or which shall be made, under the authority of the United States, shall be the supreme law of the land; and the judges in every state shall be bound thereby, anything in the Constitution or laws of any state to the contrary notwithstanding.

31 U.S.C. § 3124(a) (1988):

Stocks and obligations of the United States Government are exempt from taxation by a state or political subdivision of a state. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax, except--

(1) a nondiscriminatory franchise tax or other nonproperty tax instead of a franchise tax, imposed on a corporation; and

(2) an estate or inheritance tax.

4 U.S.C. § 111: (1985)

The United States consents to the taxation of pay or compensation for personal service as an officer or employee of the United States, a territory or possession or political subdivision thereof, the government of the District of Columbia, or an agency or instrumentality of one or more of the foregoing, by a duly constituted taxing authority having jurisdiction, if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation.

STATEMENT OF THE CASE[1]

Petitioners, three retired federal employees, seek a determination that the portion of their retirement distribution from the Civil Service Retirement and Disability Fund ("Fund")[2] comprised of interest earned on federal obligations[3]

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[1]This case is based on the Stipulation of Facts printed at App. C-1.

[2]As part of the Stipulation of Facts the parties submitted the Annual Report of the Fund for the fiscal year ending September 30, 1986 (the "Annual Report" which is printed in the Lodging included with this petition at L-1) which provides a comprehensive description of the Fund

is exempt from Minnesota income tax. Respondents, the Minnesota Department of Revenue and its Commissioner, denied Petitioners' request for a refund of Minnesota state income tax paid on the portion of their distributions attributable to interest on federal obligations received in 1986.

The Fund was established by the Congress of the United States in 1920. 5 U.S.C. § 8331 et seq (Supp. 1993). The Fund receives contributions from employees, employing agencies and the United States Treasury but its sole source of income is from interest on federal obligations. 5 U.S.C. § 8348(c) (Supp. 1993). The Fund pays administrative expenses and distributes benefits primarily to retired federal employees.

The Secretary of the Treasury is required to invest those portions of the Fund not immediately required for payments in interest-bearing securities of the United States or obligations guaranteed by the United States. 5 U.S.C. § 8348(c) (Supp. 1993). The Fund as of September 30, 1986 held approximately $154 billion of federal obligations.[4]

The total federal interest earned by the Fund for fiscal years ending September 30, 1986 and 1987, was $15,121,237,000 and $16,121,768,000 respectively. The total benefits paid to federal retirees by the Fund for fiscal years ending September 30, 1986 and 1987 were $24,636,476,000

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and its operations prepared by the Office of Personnel Management.

[3]The term "federal obligations," as used in this Petition, refers to the United States government securities held by the Fund other than GNMA securities. The terms "federal interest" and "interest on federal obligations" refer to all of the interest earnings of the Fund other than the interest earned on GNMA securities and the special Treasury credits in accordance with the judgment entered by the Hennepin County District Court, trial court herein.

[4]The Fund is the largest holder of federal obligations and during the tax year in question owned approximately 7% of the total debt obligations of the United States of America. Department of the Treasury, Monthly Statement of the Public Debt of the United States, September 30, 1986, p.1.

and $25,720,012,000 respectively. The total federal interest earned by the Fund expressed as a percent of total benefits paid to retirees was approximately 61.4% in fiscal year 1986 and approximately 62.7% in fiscal year 1987.

For income tax purposes, the Fund is treated as a qualified pension trust under Internal Revenue Code ("I.R.C.") § 401(a) and is exempt from income tax under I.R.C. § 501(a).[5] The payments received by a retiree from the Fund are subject to federal income tax under I.R.C. § 72. Under I.R.C. § 72, the payments received are excluded from gross income for federal and state tax purposes to the extent of voluntary, post-tax contributions to the Fund. All payments received, other than post-tax contributions, are taxable as ordinary income for federal tax purposes.

On December 14, 1990, Petitioners filed suit against Respondents seeking a refund. Petitioners first raised the federal question at issue here in the Complaint served upon Respondents and filed with the District Court. In their Complaint, Petitioners stated the issues as follows:

> The interest income from U.S. Government securities, such as those held by the Fund, is exempt from taxation by the State of Minnesota pursuant to 31 U.S.C. § 3124(a)....

Petitioners' Complaint dated December 14, 1990.

Petitioners and Respondents agreed on all material facts concerning the case in a Stipulation of Facts (App. C-1) and on March 2, 1992 filed simultaneous motions for summary judgment which were considered by the trial court, the

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[5]The terms "qualified pension trusts" and "qualified retirement plans" as used in this Petition refer to pension plans which meet all of the requirements of I.R.C. § 401(a) and, thus, qualify for treatment as tax exempt entities.

Honorable Peter J. Lindberg, Hennepin County District Court. In its Memorandum in Support of Motion for Summary Judgment, Petitioners argued that Minnesota's tax on that portion of the Fund's distributions attributable to interest earned by the Fund on federal obligations violated 31 U.S.C. § 3124(a), 4 U.S.C. § 111 and the constitutional doctrine of intergovernmental tax immunity. Petitioners' Memorandum in Support of Motion for Summary Judgment dated March 2, 1992.

The trial court granted in part and denied in part Petitioners' motion and awarded Petitioners refunds of state income tax paid on the portions of their annuities attributable and traceable to interest earned by the Fund on United States government securities.[6] The trial court concluded:

> The Fund does invest in U.S. government securities. The Fund maintains itself partly through the interest paid on those securities by the federal government. The burdens of taxation (by the federal government) pass through the Fund and fall upon the retirees. It seems logical that the benefit of an exemption to state income tax should also pass through the Fund to the retirees. The Court is further persuaded in favor of granting the exemption by the holding in American Bank. [American Bank & Trust Co. v. Dallas County, 463 U.S. 855 (1983).] The Court believes a ruling against the exemption would be based on the type of formalistic distinction expressly rejected by the U.S. Supreme Court. Therefore, that portion of each retiree's annuity traceable to interest on U.S. obligations is exempt from state income tax.

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[6]The trial court excluded from the refund award interest earned on Government National Mortgage Association ("GNMA") obligations and certain special credits from the United States Treasury. The Petitioners do not seek an exemption from state income tax for interest earned on GNMA securities or the special Treasury credits.

App. B-6.

Judgment was entered on May 28, 1992 and Respondents appealed therefrom. After granting accelerated review, the Minnesota Supreme Court reversed and ordered judgment for Respondents. The Minnesota Supreme Court ruled that:

(1) Neither the amount of the United States Civil Service pension benefits provided by the Civil Service Retirement System nor the amount of the Minnesota income tax payable thereon is measured by or computed on or dependent in any way on the amount of interest received by the Civil Service Retirement and Disability Fund by reason of its ownership of United States securities.

(2) 31 U.S.C. § 3124(a) (1988) does not require Minnesota to characterize annuity payments to retired federal employees as pass through distributions of tax exempt interest in the face of the provisions of I.R.C. § 72 (1988 & Supp. III 1991) and Rev. Rul. 55-61 1955-1 CB40 and the decision of the United States Supreme Court in Davis v. Michigan Department of the Treasury, 489 U.S. 803 (1989).

Meunier v. Minnesota Dep't of Revenue, No. C4-92-1626 (Minn. July 23, 1993) (App. 1). The Minnesota Supreme Court also rejected Petitioners' argument that Minnesota's tax discriminates against them as retired federal employees in violation of 4 U.S.C. § 111. Meunier, at 10 (App. A-11).

REASONS FOR GRANTING THE WRIT

The Petitioners urge this Court to grant their Petition for Writ of Certiorari to (1) resolve the conflict that resulted when the Minnesota Supreme Court decided a federal question in a way that conflicts with the decision of the Vermont Supreme Court in Keys v. Vermont Department of Taxes, 552 A.2d 418 (Vt. 1988), cert. denied, 485 U.S. 1035 (1988) and other state courts of last resort and (2) determine the proper application of two important federal statutes limiting the taxing power of states which the Minnesota Supreme Court has applied in a way that conflicts with this Court's decisions in American Bank & Trust Company v. Dallas County, 463 U.S. 855 (1983) and Davis v. Michigan Department of Treasury, 489 U.S. 803 (1989).

The legal issues raised in this case will directly determine whether or not the immunity from state income taxation contained in 31 U.S.C. § 3124(a) applies to the largest holding of federal obligations and the distributions received by federal retired workers throughout the United States. It is imperative that the United States Supreme Court ensure uniform treatment of retired federal employees under the various state income tax schemes. This case will provide necessary guidance regarding the application of 31 U.S.C. § 3124(a) to private and state qualified retirement plans, as well as to the Fund, which is operated for the benefit of federal retirees. This case will settle the conflicting case law concerning whether 31 U.S.C. § 3124(a) applies to interest earned by qualified retirement plans as defined in I.R.C. § 401 and, thus, whether states may tax federal interest earned by the retirement plan of almost every worker in the United States. Except for the decision of the Vermont Supreme Court in Keys v. Vermont Department of Taxation, 552 A.2d 418 (Vt. 1988), cert. denied, 485 U.S. 1025 (1988), the application of this federal statute to interest earned by a qualified retirement

plan has not been addressed by any other state or federal court.[7]

The primary reason for the constitutional and statutory prohibition on state taxation of federal obligations and the interest earned on federal obligations is to ensure that federal obligations are an attractive investment. See New Jersey Realty Title Ins. Co. v. Division of Tax Appeals of New Jersey, 338 U.S. 665, 675 (1950) (citing Smith v. Davis, 323 U.S. 111, 117 (1944). The ability of the federal government to operate is based on its ability to attract investors for its debt obligations. This Court must resolve the conflict between state courts of last resort concerning the state tax effect of investments in federal obligations for qualified retirement plans. Certainty concerning state tax treatment is necessary to foster and protect the investment attractiveness of federal obligations. Because administrators of qualified retirement plans must make their investments based on strict fiduciary duties (see 29 U.S.C. § 1104 (1985)), investment in federal obligations will be discouraged if there is uncertainty regarding the state income tax treatment of the interest. Any uncertainty regarding state income taxation of federal interest will have an adverse impact on the marketability of federal obligations to retirement plans.

This Court must act as the final arbitrator concerning a basic constitutional right of the federal government to have its debt obligations and interest earned on them exempted from state taxation. There is no opportunity for legislative recourse to rectify this situation. Congress has passed a statute, 31 U.S.C. § 3124(a), which defines the exemption in the broadest possible terms. One of the factors underlying the

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[7]This case also addresses state income tax treatment of federal interest earned by "conduit" or "pass through" entities. "Pass through" entities pass through the tax burden on income they earn to the beneficiaries of the income. Pass through entities include partnerships and common law trusts, as well as retirement plans and mutual funds.

constitutional concept of intergovernmental tax immunity is that the federal government has no recourse to the state ballot box to protect itself against unlawful taxation of its obligations by the states. Under our federal system of government, this Court must act as the guardian of this fundamental right of the federal government.

ARGUMENT

A. THE MINNESOTA SUPREME COURT'S APPLICATION OF 31 U.S.C. § 3124(a) DIRECTLY CONFLICTS WITH DECISIONS OF OTHER STATE COURTS OF LAST RESORT AND THIS COURT.

By failing to apply the state tax immunity of 31 U.S.C. § 3124(a) to the federal interest portion of Petitioners' distributions, the court in Meunier has ignored the plain language of that statute and the constitutional provisions on which that statute is based. The Meunier court's decision contradicts the interpretation of 31 U.S.C. § 3124(a) given by other state courts of last resort and this Court in American Bank & Trust Co. v. Dallas County, 463 U.S. 855 (1983).

31 U.S.C. § 3124(a) (1988) provides that:

> Stocks and obligations of the United States Government are exempt from taxation by a state or political subdivision of a state. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax, except--
>
> (1) a nondiscriminatory franchise tax or another nonproperty tax instead of a franchise tax,

imposed on a corporation; and

(2) an estate or inheritance tax.

This Court's decisions have treated 31 U.S.C. § 3124(a) as principally a restatement of the constitutional rule against state taxation of federal obligations. Memphis Bank & Trust Co. v. Garner, 459 U.S. 392, 397 (1983). Beginning with McCulloch v. Maryland, 17 U.S. 316 (1819) and Weston v. City Council of Charleston, 27 U.S. 449 (1829), this Court has relied upon the United States Constitution's supremacy clause (U.S. Const. art. VI, cl. 2) and borrowing clause (U.S. Const. art. I, sec. 8, cl. 2) to immunize federal obligations from state taxation. This Court has found that violations of 31 U.S.C. § 3124(a) also violate the constitutional rule that states cannot subject federal obligations to state taxation without specific congressional consent. 1st National Bank v. Bartow Cty. Assrs., 470 U.S. 583, 593 (1985).

The Minnesota Legislature recognizes the tax immunity imposed by federal law and provides for the following subtraction from taxable income:

(1) interest income on obligations of any authority, commission, or instrumentality of the United States to the extent includable in taxable income for federal income tax purposes but exempt from state income tax under the laws of the United States.

Minn. Stat. § 290.01, Subd. 19b (Supp. 1992).

In American Bank, this Court mandated broad application of the 31 U.S.C. § 3124(a) immunity. 463 U.S. at 862-63. A state tax is barred if federal obligations are considered, either directly or indirectly, in computing the tax. Id.

This state tax immunity for federal interest is preserved

even though the taxpayer receives the federal interest from a qualified pension plan trust or a mutual fund which holds the federal obligations and distributes the interest income.[8] The only case to address whether a state may tax the federal interest portion of distributions made from a qualified pension plan trust, Keys v. Vermont Department of Taxes, 552 A.2d 418 (Vt. 1988), cert. denied 485 U.S. 1025 (1988), ruled that 31 U.S.C. § 3124(a)'s state tax immunity applies to such distributions. Likewise, every state court which has addressed the issue, including the Minnesota Supreme Court in Yurista v. Commissioner of Revenue, 460 N.W.2d 24 (Minn. 1990) has found that 31 U.S.C. § 3124(a)'s state tax immunity applies to distributions from a mutual fund.

Despite the above authorities, the Minnesota Supreme Court in Meunier has refused the state tax immunity for recipients of distributions from the Fund. The Meunier court's interpretation of 31 U.S.C. § 3124(a) contradicts the Vermont Supreme Court's decision in Keys v. Vermont Department of Taxes, 552 A.2d 418 (Vt. 1988), cert. denied, 485 U.S. 1025 (1988), the decisions of several other state courts of last resort and this Court's decision in American Bank.

The Minnesota Supreme Court's decision in Meunier means that distributions by the Fund will be treated differently than distributions by a private qualified retirement plan under Keys. The court in Meunier has reached its decision despite the identical nature of the Fund and the retirement plan in Keys. Because no meaningful differences exist between these retirement plans, there is no reason for different tax treatment of their distributions.

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[8]A mutual fund is a registered investment company, regulated under the Investment Act of 1940 and subject to the provisions of I.R.C. § 851-860G, which invests in marketable securities and sells its shares to allow its shareholders to invest in a diversified portfolio of marketable securities.

If Meunier stands, then federal interest distributions from qualified retirement plans like the Fund will also receive different state tax treatment than mutual fund distributions receive. However, the differences between qualified retirement plans, like the Fund, and a mutual fund do not justify different tax treatment. Qualified retirement plans and mutual funds share the characteristic which is fundamental to determining the issue in this case: both entities pass through the tax burden for income earned by the entity to the persons receiving distributions from the entity. Given this essential similarity, distributions from qualified retirement plans like the Fund require the same tax treatment which mutual fund distributions receive.

The Court should grant this Petition for Writ of Certiorari to address the Minnesota Supreme Court's misapplication of 31 U.S.C. § 3124(a).

1. THE MINNESOTA SUPREME COURT'S TREATMENT OF THE FUND'S DISTRIBUTIONS CONFLICTS WITH THE VERMONT SUPREME COURT'S DECISION IN KEYS V. VERMONT DEPARTMENT OF TAXES, 552 A.2d 418 (Vt. 1988), CERT. DENIED, 485 U.S. 1025 (1988).

The Minnesota Supreme Court's decision allowing state taxation of the Fund's distributions attributable to federal obligation interest directly contradicts the decision of the Vermont Supreme Court in Keys v. Vermont Department of Taxes, 552 A.2d 418 (Vt. 1988), cert. denied 485 U.S. 1025 (1988).

Keys is the only state or federal decision which has previously addressed taxation of a qualified retirement plan's distribution attributable to interest on federal obligations. The plaintiff in Keys received a distribution of $141,000 from a private qualified retirement plan of which $35,000 was derived

from the retirement fund's investment in a mutual fund which owned only federal obligations. Id. The Keys court held that the federal interest earned by the retirement plan on that investment and distributed to the taxpayer is properly characterized as income derived from federal obligations and exempt from state taxation under 31 U.S.C. § 3124(a). Id.[9]

In Meunier, however, with facts nearly identical to those in Keys, the Minnesota Supreme Court refused to immunize from state tax the federal interest portion of distributions from the Fund. Because the Vermont and Minnesota Supreme Courts both applied 31 U.S.C. § 3124(a) to a qualified retirement fund and reached opposite holdings, this Court should grant Petition for Writ of Certiorari to resolve the conflict. See Sup. Ct. R. 10.1(b).

There are no meaningful differences between the retirement plan in Keys and the one in Meunier. Both retirement plans invested solely in federal obligations. Both retirement funds are qualified retirement plans under I.R.C. § 401(a). Both retirement funds are exempt from taxation pursuant to I.R.C. § 501(a). Distributions from both retirement funds are also treated the same by I.R.C. § 72.[10]

Like the retirement fund in Keys, the Fund itself receives no benefit from the tax-exempt nature of the interest earned on federal obligations held by the Fund. Because the Fund is not a taxable entity, all incidents of income taxation, both federal

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[9]This case was considered by the Vermont Supreme Court along with a companion case in which it found that distributions from mutual funds holding United States government securities were tax immune. See In re Thomas C. Sawyer Estate, 546 A.2d 784 (Vt. 1987). The lower court decision, Keys v. Vermont Department of Taxes, No. 511-83-W.M (Windsor County Superior Court Nov. 25, 1985), ("Keys trial court") is printed at App. E-1. Keys, like Meunier, was decided on stipulated facts.

[10]The effect of I.R.C. § 72 is to exempt from federal taxation a portion of each distribution which can be attributed to contributions to the respective retirement funds made by an employee with post-tax dollars (in other words, the return of "basis" to the recipient).

and state, commence upon the receipt of income by the beneficiaries of the Fund. The retirees, not the Fund, are the only possible recipients of any tax assessment on the interest earned on these government securities.[11] An assessment of state income tax on the interest portion of the distributions is, in reality, a tax on interest derived from federal obligations prohibited by 31 U.S.C. § 3124(a).

The Minnesota Supreme Court did not directly address the Keys holding in Meunier. The court's only attempt to distinguish Keys was in a footnote which notes that the retirement plan in Keys maintained a separate account for the taxpayer, because it was a "defined contribution plan," while the Fund does not maintain separate accounts for each participant, because it is a "defined benefit plan."[12] Meunier, n.5. at 8-9 (App. A-9). The Meunier court's reasoning fails to either support its conclusion or justify its decision.

The factual distinctions between a defined contribution plan and a defined benefit plan are irrelevant to the application of 31 U.S.C. § 3124(a). Both types of retirement plans are taxed identically under the provisions of subchapter D of the Internal Revenue Code. The only difference in treatment under the Internal Revenue Code relates to the limitations on benefits and contributions under I.R.C. § 415. For the purposes of the application of tax immunity of 31 U.S.C. § 3124(a), both types of qualified plans are tax exempt plans where the tax burden of the earnings on the plan falls on the retiree when the retiree receives distributions from the plan.

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[11]If this Court does not grant this Petition the ruling of the Minnesota Supreme Court will effectively eliminate the tax exemption for the over seven percent (7%) of the total debt obligations of the federal government owned by the Fund.

[12]In a defined contribution plan, the amount of a person's contributions are fixed by the plan document, but the amounts available for payment during a person's retirement are not fixed. In a defined benefit plan, such as the Fund, the amount of the contributions may vary but the amount of the retirement benefit is set by the plan documents.

If this Court does not grant Petition for Writ of Certiorari in the instant case, the reported legal precedence concerning the scope of 31 U.S.C. § 3124(a) as applied to qualified retirement plans will be contradictory. The tax immunity would be available to beneficiaries of private qualified retirement plans which invest in federal obligations but would not be available to beneficiaries of the Fund. This conflict must be resolved to dispell the uncertainty cast on state taxation of the federal interest portion of distributions from qualified retirement plans.

2. THE MINNESOTA SUPREME COURT'S DECISION DIRECTLY CONFLICTS WITH AMERICAN BANK & TRUST CO. V. DALLAS COUNTY, 463 U.S. 855 (1983).

The Minnesota Supreme Court's decision violates both the plain language of 31 U.S.C. § 3124(a) and the expansive interpretation of that statute given by this Court in American Bank. This Court should grant the Petition for Writ of Certiorari to address the Meunier court's misinterpretation. See Sup. Ct. R. 10.1(c).

In American Bank, this Court stated that 31 U.S.C. § 3124(a)'s exemption is "sweeping":

> Absent a clearly expressed legislative intention to the contrary, [the statutory] language must ordinarily be regarded as conclusive...the exemption for federal obligations provided by [31 U.S.C. § 3124(a)]...is sweeping; with specific exceptions, it 'extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly in the computation of the tax.'

463 U.S. at 862 (citing Memphis Bank & Trust Co. v. Garner, 459 U.S. 392, 395-96 (1983) (emphasis in original) (citations omitted). Thus, if federal obligations or the interest thereon are even taken into account in determining state taxation, this Court has interpreted such a tax to be invalid. Id. at 864.

In American Bank, the unlawful tax was based on the bank's assets and did not allow a deduction for those assets which were federal obligations. 463 U.S. at 863. This Court found that "[p]lainly, such a tax takes into account, at least indirectly, the federal obligations that constitute a part of the bank's assets." Id. (citations omitted). The tax in question in the American Bank case was a property tax levied on shareholders who owned shares of stock in banks. The Texas tax, in effect, "passed through" ownership of the bank's assets proportionately to the bank's shareholders for property tax purposes.[13] The first tax assessment on the federal obligations was not against the banks themselves but, rather, against persons holding stock in the banks. In other words, Texas was attempting to indirectly tax the value of federal obligations where it was prohibited from taxing the federal obligations directly. This Court struck down such an attempt to indirectly tax federal obligations. 463 U.S. at 862-63. In a similar manner, the retirees in Meunier are the recipients of the first tax assessment on the interest earned on the Fund's federal obligations because of the pass through nature of the Fund. Thus, an assessment of state income tax on the interest portion of the Fund's distributions is a direct tax on the federal interest.[14]

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[13]The structure of the Texas property tax scheme on bank shares made the bank, for the purposes of the tax, a "pass through" entity in the same manner that retirement plans, mutual funds, partnerships, and common law trusts are "pass through" entities for income tax purposes.

[14]As the trial court indicated in Keys: "all incidents of taxation both federal and state commence upon taxpayer's receipt of income. An assessment of state income tax on [the federal interest portion] of the

In Meunier, the court quoted American Bank but misapplied the holding by summarily concluding that "[n]either the amount of the annuity payments nor the amount of the Minnesota taxes is measured by or computed on or dependent in any way on the amount of interest received by the Fund by reason of its ownership of United States securities." Meunier, at 6 (App. A-6) (emphasis added). The court also incorrectly reasoned that Minnesota's "income tax is computed only on the amount of a retiree's annuity payments, and because the tax is neither computed on nor measured by, either directly or indirectly, the amount of income realized by the Fund from U.S. securities, it does not violate 31 U.S.C. § 3124(a) (1988)." Meunier, at 7 (App. A-7).

These conclusory determinations by the Minnesota Supreme Court are unsupportable by either the plain language of 31 U.S.C. § 3124(a) or the interpretation of that statutory language by this Court in American Bank and its predecessors. The statute only requires that the federal interest be "considered in computing a tax" and does not require that the tax be directly "measured" by the amount of the federal interest or that the amount of the payment be "dependent in any way" on the amount of federal interest. The tax struck down by this Court in American Bank involved no calculation or measurement of the amount of the federal obligations:

> (T)here can be no question that federal obligations were considered in computing the bank shares tax at issue here. In context, the word "considered" means taken into account, or included in the accounting. The tax at issue was computed by using an "equity capital formula," which involved determining the amount of the bank's capital assets, subtracting from that figure the bank's liabilities

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distribution was, in reality, a direct tax on interest derived from federal obligations prohibited by [31 U.S.C. § 3124(a)]." Keys trial court at 11 (App. E-10).

> and the assessed value of the bank's real estate, and then dividing the result by the number of shares...Plainly, such a tax takes into account, at least indirectly, the federal obligations that constitute a part of the bank's assets.

American Bank, 463 U.S. at 862-63 (citations omitted). The Minnesota income tax is also applied to the entire distribution received by federal retirees. A portion of that gross income is attributable to federal interest and is, thus, "considered" for purposes of Minnesota income taxation.[15]

The Minnesota Supreme Court's argument that the amount of the annuity payments is not "dependent in any way" on the amount of interest received by the Fund misconstrues American Bank. The shareholders of two Texas banks with equal asset values would have paid exactly the same amount of tax under the Texas statute even if one bank owned nothing but federal obligations and the other bank owned no federal obligations. Likewise, it is irrelevant that the annuity payments to the Petitioners would be the same regardless of the rate of interest paid on the federal obligations owned by the Fund. 31 U.S.C. § 3124(a) prohibits states from imposing property taxes or income taxes on ownership interest or payments which consider "federal obligations or the interest on federal obligations directly or indirectly."

Meunier's application of 31 U.S.C. § 3124(a) is based on the "formalistic distinctions" that have been invalidated by this

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[15]The position of the Minnesota Supreme Court is reminiscent of Idaho's defense of the Idaho state tax which prompted the passage of 31 U.S.C. § 3124(a). Idaho argued that:

> ...its tax need not exempt the interest received on federal obligations, because it was imposed on the individual and was merely measured by his net income, rather than being imposed on the income itself.

American Bank, 463 U.S. at 866 (emphasis added).

Court's interpretation of the statute. This Court should grant this Petition for Writ of Certiorari to ensure application of this constitutionally mandated immunity to prohibit all forms of state taxation of federal interest.

3. THE MINNESOTA SUPREME COURT'S DECISION CONFLICTS WITH OTHER STATE COURTS OF LAST RESORT CONCERNING THE TAX TREATMENT OF FEDERAL INTEREST DISTRIBUTIONS OF CONDUIT ENTITIES.

The Minnesota Supreme Court's ruling in Meunier also conflicts with its own decision in Yurista v. Commissioner, 460 N.W.2d 24 (Minn. 1990) and the decisions of several other state courts of last resort which bar state taxation of distributions from "conduit" or "pass through" entities such as mutual funds which own federal obligations.[16] Because the Fund is a "conduit" or "pass through" entity whose pertinent tax characteristics are identical to a mutual fund, the Court should grant this Petition for Writ of Certiorari to resolve this conflict among several state courts of last resort. See, Sup. Ct. R. 10.1(b).

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[16]Every state which has addressed the issue has held that distributions from mutual funds attributable to income from federal obligations are exempt from state income taxation. See Matz v. Department of Treasury, 401 N.W.2d 62 (Mich. 1986) (holding that dividends from mutual fund which invested only in federal obligations are immune from state taxation); Andras v. Illinois Dep't of Rev., 506 N.E.2d 439 (Ill. App. Ct.), appeal den., 515 N.E.2d 100 (Ill. 1987), cert. denied, 485 U.S. 960 (1988) (same); Brown v. Franchise Tax Bd., 242 Cal. Rptr. 810 (Cal. Ct. App. 1987) (same); In Re Thomas C. Sawyer Estate, 546 A.2d 784 (Vt. 1987) (same); Capital Preservation Fund v. Dep't of Rev., 429 N.W.2d 551 (Wis. Ct. App. 1988) (same); Borg v. Dep't of Rev., 774 P.2d 1099 (Or. 1989) (same); Comptroller v. First United Bank, 578 A.2d 192 (Md. 1990) (same); Everett v. Dep't of Rev. & Fin., 470 N.W.2d 13 (Iowa 1991) (same).

A "conduit" or "pass through" entity is itself not subject to tax. Rather, the tax burden for income earned by the entity is "passed through" to the persons receiving distributions from the entity. Generally, corporations are considered non-conduit entities, while partnerships and trusts are considered "pass through" entities for tax purposes. I.R.C. §§ 652(b), 661(c), 701, and 702(a); Commissioner v. Culbertson, 337 U.S. 733, 742 (1949).[17]

The parties agree about the federal tax treatment of the Fund and its distributions: the Fund is a qualified retirement plan under I.R.C. § 401(a); it is exempt from taxation pursuant to I.R.C. § 501(a); its distributions are subject to the provisions of I.R.C. § 72, including provisions for the tax free return of post-tax contributions. Stipulation of Facts at ¶8 (App. C-5). In other words, like every other qualified retirement fund in the United States, the Fund does not pay any tax on the income it earns. Such income is taxed when distributed to the retirees. Under the provisions of I.R.C. § 72 the retirees do not pay tax on their contributions which were not deductible at the time the contributions were made (usually referred to as "post-tax" contributions). However, retirees pay federal tax on the remaining portion of their distributions consisting of tax deductible contributions and the earnings of the Fund. In tax parlance, the tax burden on the earnings of any qualified retirement plan "passes through" to the beneficiaries. Because the Fund is a tax exempt entity which distributes its earnings to its beneficiaries, the tax immunity of 31 U.S.C. § 3124(a) is preserved for the federal retirees receiving distributions from the Fund.[18]

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[17]The four principal types of pass through entities for tax purposes are common law trusts, partnership, mutual funds and qualified retirement plans. There are no reported decisions which question the application of 31 U.S.C. § 3124(a) to distributions of partnerships and common law trusts.

[18]The rationale for this rule is obvious. If the beneficiaries of a pass

The Fund is a trust entity which, by its very nature, is a "pass through" entity analogous to a mutual fund for the purposes of the tax immunity. Congress has determined that the conduit principles underlying common law trusts apply to the Fund and the other qualified retirement plans because only the beneficiaries and not the trusts are subject to taxation. See I.R.C. §§ 401(a) and 501(a). The statutory framework of a qualified retirement plan is analogous to a common law trust because a common law trust is not subject to tax but its beneficiaries are taxed on the income earned by the trust on an annual basis. See I.R.C. § § 651 and 652.

The court in Meunier relies upon I.R.C. § 72 and Rev. Rul. 55-61 1955-1 CB 40 to deny pass through treatment for the 31 U.S.C. § 3124(a) tax immunity. These authorities do not support the court's conclusion and their misapplication have created conflict between the Minnesota Supreme Court and other state courts of last resort.

The Minnesota Supreme Court cites I.R.C. § 72 for the proposition that this section does not "allow qualified pension trusts to make income distributions which retain the same character in the hands of the retiree when distributed as the income had when received by the trust." Meunier, at 9 (App. A-9). However, because I.R.C. § 72 requires that the tax characteristics of post-tax contributions retain their tax characteristics when distributed to a retiree, this provision demonstrates that the Fund is viewed as a "pass through" entity for tax purposes and that the "characteristics" of amounts invested in the Fund are not eliminated when distributed to its beneficiaries. The Fund's distributions are characterized based on their sources.

The Meunier court's reliance on Rev. Rul. 55-61, 1955-1 CB 40 is also misplaced. Revenue rulings are not binding

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through entity are not protected by the tax immunity on federal interest, no taxpayers would be able to avail themselves of the exemption since the pass through entity is exempt from both state and federal taxes.

precedent. Helvering v. New York Trust Co., 292 U.S. 455, 468 (1933) (where this Court declined to follow several revenue rulings and stated that revenue rulings "have none of the force or effect of Treasury Decisions and do not commit the Department to any interpretation of the law"). Moreover, this ruling addresses whether municipal bond interest distributions are taxable for federal purposes.[19]

Without any controlling legal authority, the Minnesota Supreme Court in Meunier has refused to recognize the pass through characteristics of the Fund. This failure means that federal interest distributions from the Fund will impermissibly be treated differently than federal interest distributions from a mutual fund, partnership or a common law trust.

In Meunier, the Minnesota Supreme Court attempts to distinguish the instant case from mutual fund cases based on reasons that are irrelevant to the applicable legal principles. The court points to a number of irrelevant factual differences between mutual funds and the Fund, including that mutual fund shares are "acquired voluntarily with after tax dollars and held as an investment" and that a "mutual fund is required to distribute its net income annually." Meunier, at 7 (App. A-8).

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[19]The trial court in Keys properly distinguished the difference between the federal tax immunity for municipal bond interest and the immunity from state tax for interest on federal obligations:

> The Code sections referred to in the Commissioner's conclusions, I.R.C.§ § 652(b), 661(b) and 852, determine the tax-exempt status of interest income earned on state and municipal obligations under I.R.C. § 103(a)(1). This exemption is distinctly different from the constitutional and statutory immunity from state taxation of interest income earned on federal obligations. The statutory exemption from federal income taxation of interest on state and municipal obligations, I.R.C. § 103(a)(1), is an act of grace, not of constitutional necessity. Therefore, Section 103(a)(1) exemptions must be narrowly construed.

Keys trial court at 6 (App. E-5) (citations omitted).

These factual distinctions do not impact the fundamental similarity between retirement funds and mutual funds: both mutual funds and retirement funds are tax exempt entities and the initial tax burden on their earnings is imposed on their beneficiaries when they receive distributions from these entities. None of the court's factual distinctions support a determination that a mutual fund is, and the Fund as a qualified retirement plan is not, a conduit or pass through entity.[20]

The Minnesota Supreme Court's failure to distinguish mutual funds and the Fund does not justify the divergent opinions of Meunier and other state courts of last resort. The Minnesota Supreme Court's decision stands alone as the only ruling by any court denying the application of 31 U.S.C. § 3124(a) to any type of conduit or pass through entity. This Court needs to accept review of this case to eliminate confusion concerning state taxation of federal interest earned by pass through entities other than mutual funds.

B. THE MINNESOTA SUPREME COURT'S DECISION CONFLICTS WITH THIS COURT'S DECISION IN DAVIS V. MICHIGAN DEPARTMENT OF TREASURY, 489 U.S. 803 (1989).

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[20]The Minnesota Supreme Court also misstates the legal basis for its earlier ruling on the tax treatment of mutual fund distributions:

> The effect, then of the Yurista decision was simply to enforce compliance with 31 U.S.C. § 3124(a) by requiring reciprocal recognition by the state of the doctrine of intergovernmental tax immunity honored by the federal government at I.R.C. § 852(b)(5).

Meunier, at 8 (App. __). However, the Yurista decision contains not a single reference to either the concept of intergovernmental tax immunity or I.R.C. § 852(b)(5).

Minnesota's treatment of the Fund's participants is inconsistent with the treatment received by participants of private retirement plans. Such discriminatory treatment of federal retirees contravenes this Court's decision in Davis v. Michigan Department of Treasury, 409 U.S. 803 (1989) and its application of intergovernmental tax immunity and 4 U.S.C. § 111.[21]

Any attempt to differentiate between the treatment of federal retirees and other retirees is strictly prohibited by the constitutional doctrine of intergovernmental tax immunity and 4 U.S.C. § 111 (1985). Prior to the adoption of 4 U.S.C. § 111, no state income taxation of federal employees was allowed. Davis, 489 U.S. at 810. In that statute, Congress consented to state taxation of "pay or compensation" of federal officers and employees only if "the taxation does not discriminate against the officer or employee because of the source of the pay or compensation." 4 U.S.C. § 111 (1985). A state tax imposed on those who deal with the federal government is unconstitutional if the tax "is imposed [un-]equally on...similarly situated constituents of the state." Memphis Bank & Trust Co. v. Garner, 459 U.S. 392, 397 (1983) (quoting United States v. County of Fresno, 429 U.S. 452, 462 (1977)).

In Davis v. Michigan Dep't of Treasury, 489 U.S. 803, 809 (1989), this Court applied both the reference to "pay or compensation" and the non-discrimination clause contained in 4 U.S.C. § 111 to the Fund's distributions to federal retirees.

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[21]This Court has recently had occasion to examine application of the doctrine of intergovernmental tax immunity, in general, in Harper v. Virginia Dept. of Taxation, __ U.S. __, 113 S. Ct. 2510 (1993), and the Minnesota Supreme Court's interpretation of that doctrine, in particular, in Cambridge State Bank v. Remer, 457 N.W.2d 716 (Minn. 1990), vacated and remanded by this Court in Norwest Bank Duluth v. James, U.S. __, 111 S. Ct. 2881 (1991), and Cambridge State Bank v. James, 480 N.W.2d 647 (Minn. 1992), vacated and remanded again by this Court in Norwest Bank v. McClung, __ U.S. __, 113 S. Ct. 3026 (1993).

In Meunier, the Minnesota Supreme Court has refused to extend the protection afforded by 4 U.S.C. § 111 to Petitioners by holding that the state may tax Petitioners' distributions from the Fund even though distributions from private retirement plans receive the benefit of 31 U.S.C. § 3124(a) state tax immunity.[22]

If review of this case is not granted by this Court, the treatment of federal retirees will be inconsistent with the treatment received by participants in certain state or private retirement plans. In Meunier, the court does not point to any significant differences between federal retirees and private retirees which might justify such discriminatory tax treatment.

The Minnesota Supreme Court misinterpreted the non-discrimination clause in 4 U.S.C. § 111 and the Davis decision when it found no discrimination because:

> no retired state employee and no retiree from the private sector is exempt from federal or Minnesota taxation with respect to distributions from a qualified pension trust which holds state or local bonds exempt from taxation pursuant to I.R.C. § 103(a).

Meunier, at 10 (App. A-11) (emphasis added). The relevant non-discrimination inquiry, however, is not whether non-federal retirees receive an exemption for interest earned on municipal bonds but, rather, whether federal retirees receive

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[22]A distribution from a private retirement fund which invests solely in federal obligations is immune from state taxation on the interest portion of any such distribution. Keys, 552 A.2d at 418. The Minnesota Supreme Court briefly discussed Keys in its decision but did not state that it disagreed with the holding in Keys. The court distinguishes Keys on the factual basis that it involved a defined contribution plan while the Fund is a defined benefit plan. This line of reasoning would require that the application of 31 U.S.C. § 3124(a) be determined on a case by case basis for qualified retirement plans with different contribution or distribution structures.

the same protection from state taxation of federal interest as is available to any private retiree whose retirement plan invests in federal obligations.[23]

If this Court denies this Petition for Writ of Certiorari, federal retirees will not have the same state tax exemptions which are available to private retirees under the Keys decision. Such inconsistent treatment of federal workers is directly prohibited by 4 U.S.C. § 111 as interpreted by this Court in Davis.

CONCLUSION

Supreme Court review of the decision in Meunier v. Minnesota Department of Revenue is needed to determine the application to qualified retirement plans of the statutory tax immunity for interest from federal obligations. The Meunier decision directly conflicts with other state courts in the tax treatment of distributions from retirement funds and mutual funds, and review by this Court is needed to resolve these conflicts. In addition, the Minnesota Supreme Court's refusal to apply the statutory and constitutional prohibitions against discriminatory taxation of federal employees directly

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[23]The Minnesota Supreme Court also misinterpreted the statement in Davis that "...civil service retirement benefits are deferred compensation for past years of services rendered to the Government." 489 U.S. at 808. The Minnesota Supreme Court construed this phrase to mean that Minnesota is not required "to characterize annuity payments to retired federal workers as pass-through distributions of tax exempt interest." Petitioners respectfully submit that the purpose of this phrase was to make it clear that a retiree was an "employee" of the federal government for the purposes of applying 4 U.S.C. § 111. This Court's reference to distributions from the Fund as "deferred compensation" was not a directive that the Fund should be denied the "pass through" tax treatment which is available to every other qualified retirement fund in the nation.

contradicts this Court's application of those prohibitions in Davis.

Review of this case by the Supreme Court will clarify the tax treatment of federal interest earned by the Civil Service Retirement and Disability Fund and all qualified retirement plans. It is respectfully submitted that such a ruling would significantly increase the market for federal obligations resulting in a reduction of the federal government's overall borrowing costs.[24]

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[24]If the Court is not yet convinced that this case is worthy of review, the Court should request the views of the Solicitor General of the United States, whose input would be appropriate given the enormous amount of federal obligation interest involved and the substantial effect this case will have upon every federal employee and federal retiree in the United States.

For the reasons stated herein, Petitioners request the Court to grant their Petition for Writ of Certiorari to the Minnesota Supreme Court.

Dated: October 20, 1993. BEST & FLANAGAN

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State of Minnesota

In Supreme Court

C4-92-1626

Hennepin County — Coyne, J.

Robert E. Meunier, et al.,
Respondents,

vs.

Minnesota Department
of Revenue, et al.,
Appellants.

Filed July 23, 1993
Office of Appellate Courts

SYLLABUS

(1) Neither the amount of the United States civil service pension benefits provided by the Civil Service Retirement System nor the amount of the Minnesota income tax payable thereon is measured by or computed on or dependent in any way on the amount of interest received by the Civil Service Retirement and Disability Fund by reasons of its ownership of United States securities.

(2) 31 U.S.C. § 3124(a) (1988) does not require Minnesota to characterize annuity payments to retired federal employees as pass-through distributions of tax exempt interest in the face of the provisions of I.R.C. § 72 (1988 & Supp. III 1991) and Rev. Rul. 55-61 1955-1 CB and the decision of the United States Supreme Court in *Davis v. Michigan Department of the Treasury*, 489 U.S. 803 (1989).

Reversed.

Heard, considered, and decided by the court en banc.

OPINION

COYNE, Justice.

On accelerated review of summary judgment awarding plaintiffs income tax refunds on approximately 60 percent of the United States civil service pension benefits received in 1986 by the plaintiffs, who are retired federal civil service employees, we reverse.

Reserving the right to introduce evidence inconsistent with the stipulated facts, the parties entered into a stipulation of facts. During calendar year 1986 each of the three named plaintiffs received retirement benefits in amounts ranging from $14,700 to $36,012 paid by the Civil Service Retirement and Disability Fund in the form of monthly annuity payments. Each plaintiff reported the gross annuity amount shown on 1986 form W-2P(A) issued by the Office of Personnel Management, Civil Service Retirement System on his 1986 United States and Minnesota income tax returns and paid the Minnesota income tax payable on that amount. In October 1990 each plaintiff filed an amended 1986 Minnesota income tax return claiming entitlement to a refund on the ground that a portion of his pension annuity payments is derived from "U.S. Government interest" exempt from state taxation pursuant to 31 U.S.C. § 3124(a) (1988). When the Department of Revenue denied their claims, the plaintiffs commenced this action. On plaintiffs' motion for summary judgment the district court awarded the plaintiffs refunds "for state income tax paid on the portions of their annuities attributable and traceable to interest earned by the Fund on U.S. government obligations." For purposes of calculating the amount of the refunds, the district court "found" that all "interest earned on U.S. securities by the Fund during a given year is deemed to be paid out to the Fund's annuitants in that year." The Department of Revenue appealed from the summary judgment, and this court accepted accelerated

review.

By the Act of May 22, 1920 Congress established the Civil Service Retirement and Disability Fund, to which employing agencies of the federal government and their employees transmit their respective mandatory contributions. Act of May 22, 1920, ch. 195, 41 Stat. 614 (1921) (codified as amended at 5 U.S.C. §§ 8301-8348 (1988 & Supp. IV 1992)). Since 1987 the Fund has comprised two separate defined benefit pension plans: (1) The Civil Service Retirement System provides a defined benefit pension based on length of service and salary level, and it administers the pensions of most federal employees hired before 1983, 5 U.S.C. §§ 8301-8351 (1988 & Supp. IV 1992); (2) the Federal Employees Retirement System implemented in 1987 provides a defined benefit pension integrated with social security.[1] 5 U.S.C. §§ 8401-8479 (1988 & Supp. IV 1992). All of the plaintiffs here receive annuity payments from the Civil Service Retirement System's pension plan.

5 U.S.C. § 8348(a) (1988) provides that the "Fund is appropriated for the payment of" benefits and certain administrative expenses incurred by the Office of Personnel Management. The Secretary of the Treasury is authorized to accept donations or gifts to the Fund contributed for the benefit of civil service employees generally, 5 U.S.C. § 8348(b) (1988), and the Secretary is directed to invest all currently available portions of the Fund which are not immediately required for payments in interest-bearing securities of the United States. 5 U.S.C. § 8348(c) (1988). The income derived from these investments constitutes part of the Fund. *Id.* The statute goes on to provide that whenever a statute authorizes new or liberalized benefits payable from the Fund, the statute is deemed to authorize appropriations

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[1] The Federal Employees Retirement System also maintains an optional Thrift Savings Plan, which has at least some of the attributes of a defined contribution plan and which is administered and maintained as a separate fund. *See* 5 U.S.C. §§ 8471-8479 (1988 & Supp. IV 1992).

to the Fund to finance the unfunded liability created by that statute. 5 U.S.C. § 8348(f) (1988).

5 U.S.C. § 8347(f) (1988) provides for the appointment of a three-member Board of Actuaries, which makes actuarial valuations of the Fund every five years or oftener and reports annually on the actuarial status of the Civil Service Retirement System, gives its advice and opinion on matters referred to it, and recommends changes the Board judges necessary to maintain the System on a sound financial basis.

At the end of each fiscal year the Secretary of the Treasury is required, on notice from the Office of Personnel Management, to credit to the Fund an amount equal to the interest on the unfunded liability computed at the interest rate used by the actuaries in their most recent valuation of the Civil Service Retirement System plus that portion of disbursements for annuities for that year which is estimated to be attributable to credit for military service for which deposits had been made. 5 U.S.C. § 8348(g) (1988). The statute also makes provision for appropriations from the general fund of the Treasury to cover the Fund's loss of income during any debt issuance suspension period occasioned by the public debt limit, 5 U.S.C. § 8348(j) (1988), and it imposes on the United States Postal Service and the Panama Canal Commission liability for certain increases in the Fund's unfunded liability. 5 U.S.C. § 8348(i) and (m) (1988 & Supp. IV 1992).

The parties have stipulated that for income tax purposes the Fund is treated as a qualified pension plan trust described in Internal Revenue Code § 401(a) (1988 & Supp. III 1991) and exempt from taxation pursuant to Internal Revenue Code § 501(a) (1988), and they have also stipulated that the Fund's annuity payments to retirees are subject to federal income tax pursuant to Internal Revenue Code § 72 (1988 & Supp. III 1991). Prior to 1986 each of the plaintiffs had recovered his cost basis so that all annuity payments received in 1986 and subsequent years are subject to federal income

taxation. *Id.*

Based on the exemption from state taxation afforded obligations of the United States by 31 U.S.C. § 3124(a), as construed in *American Bank & Trust Co. v. Trust Co. v. Dallas County*. 463 U.S. 855 (1983), plaintiffs contend that the Civil Service Retirement and Disability Fund is merely a conduit which passes the interest earned by the portion of the Fund invested in U.S. securities, together with its § 3124(a) exemption, through to retirees. The argument is, however, misconceived.

First, the plaintiffs' contention rests on an overboard reading of the *American Bank* case. In *American Bank*, *supra*, the Supreme Court held that a Texas property tax on bank shares, calculated not on the actual value of the share but instead on the value of the underlying assets — the net assets of the bank — including United States obligations owned by the bank, violated what is now 31 U.S.C. § 3124(a) (1988). Without repeating the statutory history recently summarized in *Yurista v. Comm'r of Revenue*, 460 N.W.2d 24, 26-27 (Minn: 1990), it appears necessary to call attention to Justice Blackmum's repeated emphasis in *American Bank* on the *computation* of the tax. For example, he supplied the emphasis in this quotation from *Memphis Bank & Trust Co. v. Garner*,459 U.S. 392, 395-96 (1983):

> [31 U.S.C. § 3124(a)] extends to *every form* of taxation that would require that either the obligations or the interest thereon, or both, *be considered, directly or indirectly, in the computation of the tax.*

463 U.S. at 862. Later, in discussing the reasons for the abandonment of the pre-1959 approach known as the separate incident rule, Justice Blackmum again emphasized the computation of the tax:

> Under the plain language of the 1959 amendment, however, the tax is barred regardless of its *form* if federal obligations must be considered, either directly or indirectly, in *computing* the tax.

Nothing about the *form* of the tax at issue is in any way reminiscent of the separate incident rule: it is an income tax imposed by the State of Minnesota on annuity payments received by the plaintiff retirees without reference to the underlying source of those payments. More to the point, the Minnesota tax tracks the provisions of section 72 of the Internal Revenue Code so that the tax is computed solely on the total amount of the annuity payments received in a particular year subject to reduction by the unrecovered cost basis of the annuity.[2] In turn the amount of the annuity payments is determined by the length of the retiree's service and age at retirement and by the retiree's average pay.[3] Neither the amount of the annuity payments nor the amount of the Minnesota tax is measured by or computed on or dependent in any way on the amount of interest received by the Fund by reason of its ownership of U.S. securities.

The plaintiffs' assertion that the amount of the annuity payments to retirees depends on the amount of interest earned by the Fund is wrong. The amount of a retiree's annuity payments is set by statute, 5 U.S.C. § 8339 (1988 & Supp. IV 1992), and depends on an employee's age and length of service at retirement and the employee's average wage. Subsequent adjustments

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[2] 5 U.S.C. § 8343 (1988) permits an employee to make voluntary contributions to the Fund in an amount not to exceed 10% of the employee's basic pay. Voluntary contributions are used to purchase at retirement an annuity in addition to the annuity otherwise provided. To the extent such voluntary contributions are made with after-tax dollars, the purchase price of the additional annuity would be excluded from gross income pursuant to I.R.C. § 72(b). As indicated earlier, it is stipulated that each of the plaintiffs here had recovered his cost basis prior to 1986 so that all annuity payments in 1986 and subsequent years are subject to federal income taxation.

[3] "Average pay" mens the largest annual rate resulting from averaging an employee's or Member's [Member of Congress] rates of basic pay in effect over an 3 consecutive years of creditable service****" 5 U.S.C. § 8331(4) (1988).

in annuities depend not on the Fund's income but on increases in the price index,[4] which trigger cost-of-living increases in annuities. 5 U.S.C. § 8340 (1988). Although the Board of Actuaries undoubtedly employs actuarial assumptions, including an assumed rate of inflation, assumed general salary increases, and an assumed rate of investment earnings, in their actuarial valuation of the Fund and their annual report, these reports have not effect on the amount of annuity payments to retirees. The actuarial assumptions are employed to determine the actuarial status of the Fund — that is, the Board uses actuarial assumptions to estimate the Fund's unfunded liability. The Board's determination of unfunded liability and the interest rate assumed by the actuaries in their latest valuation of the Fund, together with the estimated amount of unfunded annuity payments attributable to credit for military service, determine the amount the Secretary of the Treasury must credit to the Fund. The purposes of the reports and recommendations of the Board of Actuaries are the protection of the public interest and the maintenance of the Civil Service Retirement System on a sound financial basis.

In short, the Minnesota income tax is computed only on the amount of a retiree's annuity payments, and because the tax is neither computed on nor measured by, either directly or indirectly, the amount of income realized by the Fund from U.S. securities, it does not violate 31 U.S.C. § 3124(a) (1988).

Citing *Yurista v. Comm'r of Revenue*, 460 N.W.2d 24 (Minn. 1990), however, the plaintiffs insist they are entitled to look to the source of the funds used to make their annuity payments, that the Fund is simply a conduit through which the income from obligations of the United States is passed with its § 3124(a) tax

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[4] "Price index" means the Consumer Price Index published monthly by the Bureau of Labor Statistics. 5 U.S.C. § 8331(15) (1988).

exemption intact. Initially, it appears to us that the plaintiffs here have fallen into the same error as did the commissioner in *Yurista* — they assume "a far broader entitlement to the exemption" than approved by the court in *Yurista*. There are substantial and very significant differences between a mutual fund such as those involved in *Yurista* and the Civil Service Retirement and Disability Fund. Ownership of a specified number of shares of a mutual fund operated by a regulated investment company is acquired voluntarily with after-tax dollars and held as an investment, which can be sold or cashed at the owner's election. The mutual fund is required to distribute its net income annually, with a proportionate part of that income allocated to each outstanding share of the fund and held for the account of the owner of each share or distributed outright as the owner instructs. In either case the income, denominated either as interest or dividend, is subject to tax in accordance with the Internal Revenue Code and applicable state statutes. Moreover, when at least 50 percent of the value of total assets of a regulated investment company consists of state and municipal bonds exempt from taxation pursuant to Internal Revenue Code § 103(a) (1988), the company is qualified to pay exempt-interest dividends, which the shareholder-recipients are entitled to treat as an item of interest excludable from gross income. I.R.C. § 852(b)(5) (1988). The effect, then, of the *Yurista* decision was simply to enforce compliance with 31 U.S.C. § 3124(a) by requiring reciprocal recognition by the state of the doctrine of intergovernmental tax immunity honored by the federal government at I.R.C. § 852(b)(5). In lay terms the regulated investment company becomes a conduit through which the federal interest exemption is passed to its shareholders.

While the Civil Service Retirement Fund permits some voluntary contributions which can be used to purchase an additional annuity on retirement, any ground common to the Fund and a mutual fund ends there. All

other contributions to the fund by either employer or employee are statutorily mandated as are the amounts of the annuity payments to retirees. The fund does not allocate those contributions to be held for the account of each employee-contributor. The United States Court of Appeals for the District of Columbia has held that if there can be any vested rights at all in federal civilian service annuity, they do not accrue unless the employee is fully entitled to immediate payment under the preexisting law. *Nordstrom v. U.S.*, 342 F.2d 55 (Ct. Cl. 1965). *See also Rafferty v. U.S.*, 210 F.2d 934 (3d Cir. 1954).[5] Congress has decreed that the currently available portions of the Fund not immediately required for annuity payments are to be invested in securities of the United States. The investment direction undoubtedly was prompted by concern for the safety of the Fund rather than tax exemption because the Fund itself is treated as a tax exempt pension plan fund pursuant to I.R.C. § 401 and 501.

The annuity payments to retirees are subject to federal income taxation in accordance with I.R.C. §§ 402 (1988 & Supp. III 1991) and 72. Those sections do not allow qualified pension trusts to make income distributions which would retain the same character in the hands of a retiree which distributed as the income

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[5] *Keys v. Vermont Department of Taxes*, 149 Vt. 658, 552 A.2d 418, *cert. denied*, 485 U.S. 1035 (1988), on which plaintiffs rely, is distinguishable. On his retirement, Keys received a lump sum distribution from a defined contribution retirement plan which permitted employee-directed investment of his account. Unlike the defined benefit Fund, each participant in a defined contribution plan has a separate account and payments from that plan consist of the contributions made by or on behalf of that participant plus whatever income the funds held for that participant's account have earned. We do not suggest that payments from defined benefit plans and payments from defined contribution plans should be taxed differently, but merely observe that because a separate account is maintained for each participant in a defined contribution plan, at least the income credited to each account is directly traceable.

had when received by the trust. In fact, a revenue ruling specifically provides that interest on tax-exempt securities loses that exemption on distribution from the past:

> Although a distribution from an employees' trust meeting the requirements of section 401 of the Internal Revenue Code of 1954 is made in whole or in part from funds received by the trust as interest on tax-free securities, such distribution, when received or made available, is taxable income to the distributee in the manner and to the extent provided by section 402(a) of the Code.

Rev. Rul. 55-61, 1955-1 CB 40.

In deciding that civil service retirement benefits are subject to 4 U.S.C. § 111[6], the United States Supreme Court had this to say about the character of civil service annuity payments:

> While retirement pay is not actually disbursed during the time an individual is working for the Government, the amount of benefits to be received in retirement is based and computed upon the individual's salary and years of service. 5 U.S.C. § 8339(a). We have no difficulty concluding that civil service retirement benefits are deferred compensation for past years of service rendered to the Government. (Citations omitted). And because these benefits accrue to employes on account of their service to the Government, they fall squarely within the category of compensation for services rendered 'as an officer or employee of the United

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[6] In relevant part, 4 U.S.C. § 111 provides as follows:

> The United States consents to the taxation of pay or compensation for personal service as an officer or employee of the United States * * * by a duly constituted taxing authority having jurisdiction, if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation.

States.'

Davis v. Michigan Department of the Treasury, 489 U.S. 803, 808 (1989). Therefore, the Court held, while Michigan could impose a nondiscriminatory income tax on retired federal employees, the Michigan Income Tax Act violated principles of intergovernmental tax immunity by exempting the retirement benefits of retired state and local government employees while taxing the retirement benefits of retired federal employees. *Id.* at 817.

The plaintiffs here complain that the Department of Revenue's declination to treat approximately 60 percent of their annuity payments as exempt-interest distributions discriminates against them. In fact, however, the plaintiffs ask the Department to discriminate in their favor. No retired state employee and no retiree from the private sector is exempt from either federal or Minnesota taxation with respect to distributions from a qualified pension trust which holds state or local bonds exempt from taxation pursuant to I.R.C. § 103(c).

We conclude, therefore, that 31 U.S.C. § 3124(a) does not require Minnesota to characterize annuity payments to retired federal employees as pass-through distributions of tax exempt interests in the face of the provisions of I.R.C. § 72 and Rev. Rul. 55-61, 1955-1 CB 40, which subject those payments to taxation in the same manner as any commercial annuity, and in the face of the decision of the United States Supreme Court in *Davis v. Michigan Department of the Treasury*, which recognizes annuity payments to retired federal employees as deferred compensation subject to nondiscriminatory state taxation, pursuant to 4 U.S.C. § 111 (1988). To rule otherwise would, we believe, constitute a violation of the doctrine of intergovernmental tax immunity which, as Justice Kennedy noted in *Davis*, "had its genesis in *McCulloch v. Maryland*, 4 Wheat. 316 (1819)." 489 U.S. at 810.

Accordingly we reverse and direct entry of judgment in favor of the Minnesota Department of Revenue.

Reversed with direction to enter judgment in favor of the Minnesota Department of Revenue.

STATE OF MINNESOTA DISTRICT COURT
COUNTY OF HENNEPIN
FOURTH JUDICIAL DISTRICT

Robert E. Meunier,
Earl W. Miller and
Edward Garin,

Plaintiffs,

vs.

Minnesota Department of
Revenue, and Dorothy A. McClung,
in her capacity as Minnesota
Commissioner of Revenue,

Defendants.

ORDER

File No. 91-00043

The above-entitled matter came duly on before the undersigned, one of the Judges of the above-named Court, on the submissions of the parties, without hearing.

Plaintiffs are represented by James C. Diracles, Esquire. Defendants are represented by Thomas K. Overton, Esquire.

Based upon the arguments and submissions of counsel and upon all the files, records and proceedings herein, and the Court being fully advised in the premises,

IT IS HEREBY ORDERED:

1. Plaintiffs' motion for summary judgment is granted in part and denied in part.

2. Plaintiffs are awarded refunds, to be paid by the Defendants, for state income tax paid on the portions of their annuities attributable and traceable to interest earned by the Fund on U.S. government obligations.

3. GNMA interest shall not be included in the above award, as explained in the attached memorandum.

4. U.S. Treasury credits shall not be included in the above award, as explained in the attached memorandum.

5. Let the attached memorandum be part of this order.

6. Notwithstanding Gen. R. Prac. 125, let Judgment be entered immediately.

LET JUDGMENT BE ENTERED ACCORDINGLY.

BY THE COURT:

Dated: 14 May 1992

s/s

Peter J. Lindberg
Judge of District Court

MEMORANDUM

This suit comes before the Court on the submissions of the parties, without hearing, in the posture of simultaneous summary judgment motions by both parties. Plaintiffs seek to establish an exemption for a portion of their retirement annuities from state income tax, pursuant to federal and state law. Defendants claim that the retirement annuities do not qualify, in part or in whole, for an exemption from state income tax.

Plaintiffs are all retirees. All held jobs with the federal government prior to their retirement. All are receiving retirement annuities from the same federal retirement fund ("the Fund"). In 1986 Meunier received $19,104 from the Fund, Miller received $14,700 and Garin received $36,012. All paid state income tax on the money received.

The Fund is actually an entity comprised of two

different tiers of defined pension benefits, the Civil Service Retirement System (CSRS) and the Federal Employees Retirement System (FERS). The Fund operates on a fiscal year which runs from October 1 to September 30. The Fund is required by statute to invest funds not immediately required for payment of annuities in interest-bearing securities of the United States, or in obligations guaranteed by the United States. According to the stipulations of the parties, the Fund paid out $24,636,476,000 in benefits during the 1986 fiscal year and $25,720,012,000 during the 1987 fiscal year. The Fund earned $15,121,237,000 during the 1986 fiscal year and $16,121,768,000 during the 1987 fiscal year.

Some of the interest included in the above amounts was earned on GNMA obligations. Plaintiffs are not seeking an exemption from state income tax for funds traceable to interest on GNMA obligations. According to the stipulation, GNMA certificates comprise a very small part of the Fund's total investment portfolio, less than 1 percent.

Some of the interest included in the above interest amounts was paid into the Fund by the U.S. Treasury. This money was credited to the Fund pursuant to statute. The Fund is not allowed to invest the entire body of its cash holdings due to statutory debt limitation. Therefore, the Treasury is required to compensate the Fund for the interest it could have earned if it were allowed to invest *all* of its cash holdings in U.S. government obligations. In the 1986 fiscal year, the Treasury credited the Fund with $77.8 million, or about .5 percent of the total interest earned that year. In 1987, the Treasury compensated the Fund in the amount of $20.2 million, or about .13 percent of the interest earned by the Fund that fiscal year.

Plaintiffs seek refunds from the State of Minnesota of income tax paid on that portion of their retirement annuities attributable to interest earned on U.S. government obligations. Plaintiffs find support for their

claim in 31 U.S.C. 3124(a) (1982), in Minn. Stat. §290.01, subd. 19(b)(1) (1988), and in *Yurista v. Commissioner of Revenue*, 460 N.W.2d 24 (Minn. 1990). Defendant argues that the annuities do not represent, in whole or in part, interest paid on U.S. obligations for the purpose of state income tax exemption under 31 U.S.C. 3124(a). The Court finds the Plaintiffs are entitled to an exemption from state income tax for that portion of their annuities attributable to interest earned on U.S. government obligations.

The current version of 31 U.S.C. 3124(a) reads as follows:

> Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax except —
>
> (1) a nondiscriminatory franchise tax or another nonproperty tax instead of a franchise tax, imposed on a corporation; and
>
> (2) an estate or inheritance tax.

The statute is essentially a codification of the supremacy clause of the federal constitution, which prevents state governments from impairing the federal government's ability to raise and borrow money.

The United States Supreme Court carved out an exception to the rule against states levying taxes which would burden federal obligations. This exception was called the "separate incidence" rule. The gist of the rule was that state taxes burdening federal obligations would be permitted if the obligation were taxed *indirectly*. For example, under the "separate incidence" rule, it would probably be permissible for a state to levy taxes on a share of bank stock, owned by a private individual, that was comprised partly of U.S. government obligations. The fact that the U.S.

obligations were not owned in their entirety by one individual, and the fact that they were mixed in with non-U.S. securities, would probably be considered dipositive. Under the separate incidence rule, the exemption would be denied and the state tax would be permitted.

Congress subsequently amended the statute in order to abrogate the separate incidence rule. This language was added:

> This exception extends to every form of taxation that would require either the obligations or the interest thereon, or both, be considered, *directly* or *indirectly*, in the computation of the tax . . .

Act of Sept. 22, 1959, §150(a), 73 Stat. 622, (emphasis added). The words "directly or indirectly" have since been excised from the statute. However, the U.S. Supreme Court has stated that this revision did not substantially change the statute. *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 103 S.Ct. 3369, 77 L.Ed.2d 1072 (1983).

In *American Bank*, the Supreme Court stated,

> The exemption for federal obligations provided by §3701, as amended in 1959, is *sweeping* with specific exceptions . . .

American Bank, 463 U.S. at 862, 103 S.Ct. at 3374 (1983) (emphasis added). The Court rejected formalistic or hypertechnical exceptions to state tax exemptions. The separate incidence rule was expressly rejected.

The Minnesota Supreme Court addressed the scope of 31 U.S.C. 3124 (a) in *Yurista v. Commissioner of Revenue*, 460 N.W.2d 24 (Minn. 1990). In that case a taxpayer claimed the exemption for shares in a mutual fund because the fund had invested in part in U.S. government securities. The Commissioner claimed that the proceeds of the mutual fund were dividends, not interest, and therefore were not entitled to the exemption in 31 U.S.C. 3124(a). The Supreme Court

rejected this distinction as mere "technical nomenclature" and extended the exemption to that portion of each share traceable and attributable to U.S. government security interest.

The rationale of the decision was two-fold. First, *American Bank* and the history of 31 U.S.C. 3124(a) indicate the intended scope of the exemption is expansive. Second, the mutual fund is a "conduit entity." Tax burdens are conducted through the fund and onto the taxpayer, so therefore tax benefits should also be conducted through the fund to the taxpayer. *Yurista* at 27.

The Court finds Plaintiffs' analogy of the facts in this case to those in *Yurista* to be convincing. The Fund does invest in U.S. government securities. The Fund maintains itself partly through the interest paid on those securities by the federal government. The burdens of taxation (by the federal government) pass through the Fund and fall upon the retirees. It seems logical that the benefit of an exemption to state income tax should also pass through the Fund to the retirees. The Court is further persuaded in favor of granting the exemption by the holding in *American Bank*. The Court believes a ruling against the exemption would be based on the type of formalistic distinction expressly rejected by the U.S. Supreme Court. Therefore, that portion of each retiree's annuity traceable to interest on U.S. obligations is exempt from state income tax.

Defendants argue that Plaintiffs cannot demonstrate that any portion of any annuity was actually comprised of interest on U.S. securities, because the Fund had enough non-interest assets to pay all its recipients without touching the interest earned in a given year. The Court believes it is a fair assumption that the Fund pays out the interest earned in a given year in the form of benefits and keeps its principle holdings intact to as great a degree as possible. Therefore, the Court finds that the interest earned on U.S. securities by the Fund during a given year is deemed to be paid out to the

Fund's annuitants in that year. Each annuity is exempt from Minnesota income tax in the ratio, expressed as a percentage, of the total interest earned by the Fund in a given year to the total amount of benefit paid by the Fund in that same year. For example, if the total interest earned from U.S. securities in 1986 was $15 billion and the total amount of benefits paid that year was $24 billion, then the ratio is $15 billion to $24 billion, which equals 62 percent. Each annuitant would be entitled to exempt 62 percent of his annuity from state income tax for the year 1986.

The Court qualifies its holdings in the following particulars.

First, the interest earned by the Fund on GNMA securities is not entitled to an exemption from state income tax. The Plaintiffs have not asked for this exemption, and the Court is barred from granting it by the holding in *Rockford Life Ins. Co. v. Illinois Dept. of Revenue*, 482 U.S. 183, 107 S.Ct. 2312 (1987). The U.S. Supreme Court held that GNMA certificates are guaranteed by the government, but the primary obligor is the financial institution issuing the certificate, not the U.S. government. Therefore, the certificates do not qualify as "stocks" or "obligations" of the U.S. government under 31 U.S.C. 3124(a).

Second, annuitants are not allowed an exemption for those "interest" dollars credited to the Fund by the Treasury Department. These dollars are credited pursuant to special laws compensating the Fund for interest not earned because of statutory debt limitation. The dollars credited to the Fund by the Treasury are not necessarily interest dollars *paid* on U.S. stocks or securities. The Court believes it would be overly burdensome, to the Fund and to the taxing authority, to trace the origin of the dollars credited by the Treasury.

Therefore, the amount of the Treasury credits and interest earned on GNMA certificates must be subtracted from the total interest earned by the Fund. Then the percentage of payments exempt from state

income tax can be calculated.

PJL

CASE TYPE: DECLARATORY JUDGMENT

STATE OF MINNESOTA DISTRICT COURT

COUNTY OF HENNEPIN

FOURTH JUDICIAL DISTRICT

Court File No. 91-000043

Robert E. Meunier,
Earl W. Miller and
Edward Garin,

Plaintiffs,

vs. **STIPULATION OF FACTS**

Minnesota Department of
Revenue, and Dorothy A. McClung,
in her capacity as Minnesota
Commissioner of Revenue,

Defendants.

INTRODUCTION

Plaintiffs Robert E. Meunier ("Meunier"), Earl W. Miller ("Miller"), and Edward Garin ("Garin") (jointly referred to as "Retirees"), and defendants Minnesota Department of Revenue and Dorothy A. McClung, by and through their undersigned counsel, hereby stipulate that the following facts may be taken as true and correct for purposes of the above-captioned action concerning the Civil Service Retirement and Disability Fund ("Fund") and that any documents attached hereto are true and correct copies of the originals and may be considered as evidence. This Stipulation is without prejudice to the right of either party to introduce further evidence not consistent with the facts herein stipulated.

A. INFORMATION CONCERNING PLAINTIFFS

1. Meunier

Plaintiff Meunier is a Minnesota resident residing at 8619 Greenway Avenue, South Cottage Grove, Minnesota. From 1953 to 1983 Meunier worked as a U.S. postal employee. From 1983 to the present, Meunier has received monthly annuity payments from the Fund under the Civil Services Retirement System.

Meunier timely filed his State income tax return for the year 1986 and paid tax on $19,104 he received from the fund.

Meunier timely filed an amended State income tax return for the tax year 1986 requesting a refund of the tax paid on the percentage of the payments he received from the Fund equal to the total interest from United States Government Securities earned by the Fund divided by the total benefits paid to participants from the Fund in fiscal year ending September 30, 1986.

The Minnesota Department of Revenue timely denied Meunier's claim for refund for taxable year 1986 on grounds that the payments received by him were not payments of interest on United States Government Securities exempt from state taxation under 31 U.S.C. § 3124(a) and Minn. Stat. § 290.01, subd. 20b(1) (1986).

2. Miller

Plaintiff Miller is a Minnesota resident residing at 901 Russell Avenue North, Minneapolis, Minnesota. From 1948 to 1978 Miller worked as a dispatch expeditor for the U.S. postal office in Minneapolis. From 1978 to the present, Miller has received monthly annuity payments from the Fund under the Civil Service Retirement System.

Miller timely filed his State income tax return for the year 1986 and paid tax on $14,700 he received from the Fund.

Miller timely filed an amended State income tax for the tax year 1986 requesting a refund of the tax paid on

the percentage of the Fund's distributions equal to the total interest from the United States Government Securities earned by the Fund divided by the total benefits paid to participants from the Fund in fiscal year ending September 30, 1986.

The Minnesota Department of Revenue timely denied Miller's claim for refund for taxable year 1986 on the grounds that payments received by him were not payments of interest on United States Government Securities exempt from state taxation under 31 U.S.C. § 3124(a) and Minn. Stat. § 290.01, subd. 20b(1) (1986).

3. Garin

Plaintiff Garin is a Minnesota resident residing at 2118 Sioux Boulevard, New Brighton, Minnesota. From 1941 to 1942 Garin worked as a clerk for the Army Corp of Engineers. From 1942 to 1946 Garin served in the Navy in World War II. From 1949 to 1950 Garin worked as an accountant for the U.S. Agriculture Department. From 1950 to 1954 Garin served in the Korean War. From 1954 to 1977 Garin worked for the IRS. From 1977 to the present, Garin has received monthly annuity payments from the Fund under the Civil Services Retirement System.

Garin timely filed his State income tax return for the year 1986 and paid tax on $36,012 he received from the Fund in fiscal year ending September 30, 1986.

Garin timely filed an amended State income tax return for the tax year 1986 requesting a refund of the tax paid on the percentage of the payments he received from the Fund equal to the total interest from United States Government Securities earned by the Fund divided by the total benefits paid to participants from the Fund.

The Minnesota Department of Revenue timely denied Garin's claim for refund for taxable year 1986 on grounds that the payments received by him were not payments of interest on United States Government Securities exempt from state taxation under 31 U.S.C. §

3124(a) and Minn. Stat. § 290.01, subd. 20b(1) (1986).

B. INFORMATION ON THE FUND

1. The Fund was established by the Congress of the United States in 1920 (5 U.S.C. § 8301, *et seq*). The functions of the Fund are to receive contributions from employees, employing agencies and the United States Treasury, receive income from investments, pay administrative expenses, and pay benefits, primarily annuity payments, to retired federal employees (a small portion of payments from the Fund go to disabled employees and their survivors).

2. The Fund is a defined benefit plan (FERS also has a defined contribution component which is not part of the Fund). The Secretary of the Treasury is required to invest those portions of the Fund as are not immediately required for payments from the Fund in interest-bearing securities of the United States or obligations guaranteed by the United States. The income derived from these investments constitutes a part of the Fund. The Fund makes monthly payments to retired federal employees (plus some payments to disabled federal employees and survivors of such persons) (the "Participants").

3. The Fund is comprised of two tiers of defined pension benefits, the Civil Service Retirement System ("CSRS") and the Federal Employees Retirement System ("FERS"). The CSRS was enacted in 1920 and acts as a stand-alone retirement system providing retirement benefits for long-service civil servants. The CSRS covers most federal employees hired before 1983. The FERS was implemented on January 1, 1987. The FERS is a three part pension program which uses social security as a base, provides an additional basic benefit, and allows optional participation in a Thrift Savings Plan which is separately administered and financed through a separate trust fund.

4. Both the CSRS and FERS are financed and operated through the Fund. All receipts for both the

CSRS and FERS are deposited into the Fund, and all distributions for both the CSRS and FERS are made from the Fund.

5. Federal civil service workers are covered by these "defined benefits" retirement plans. In these plans the employee's benefits are based on the amount of service and the level of salary.

6. Additions to the Fund come from mandatory withholding from the salary of current federal employees, contributions from the employees' federal agencies for current employees, appropriations from the general fund of the United States Treasury, and investment income from United States Government Securities.

7. Federal employees who are separated from government service (or transferred to a position which is not under the Fund) are eligible for a refund of contributions withheld from their salary, plus interest, if the employee has been in civilian service for at least one year, but less than five years.

8. For income tax purposes, the Fund is treated like a qualified pension plan trust under Internal Revenue Code § 401(a) that is exempt from income tax under § 501(a). The payments received by a Retiree from the Fund are subject to federal income tax under Internal Revenue Code 72. Under that provision, the payments received are excluded from gross income until the Retiree has received an amount equal to his cost (contributions to the Fund on which the employee previously paid income tax). Thereafter, all payments received are taxable as ordinary income under the IRC.

As of 1986, the Retirees had each previously recovered his cost basis on which he had previously paid tax and so the full amount of the payment each received in 1986 is includable in his federal adjusted gross income and subject to federal income taxation.

C. FINANCIAL INFORMATION

1. The following information is taken from the

Fund's annual reports and the Affidavit of Curtis J. Smith submitted by the Retirees. For the fiscal year ending September 30, 1986, the Fund's investment in interest-bearing securities of the United States were as follows:

September 30, 1986
(Dollars in thousands)

	Principal Amount	Fair Value
Marketable securities:		
U.S. Treasury bonds	$2,487,112	$2,522,276
Government National Mortgage Association participation certificates	175,000	171,453
Subtotal	2,662,112	2,693,729
Nonmarketable securities:		
Special Treasury bonds	123,463,036	123,463,036
Federal Financing bonds	14,999,990	14,999,990
Certificates of Indebtedness	13,094,550	13,094,550
Subtotal	151,557,576	151,557,576
Total investments	$154,219,688	$154,251,305

2. For the fiscal year ending September 30, 1987, the Fund's investments in interest-bearing securities of the United States were as follows:

September 30, 1987
(Dollars in thousands)

	Principal Amount	Fair Value
Marketable securities:		
U.S. Treasury bonds	$2,437,112	$2,202,013
Government National Mortgage Association participation certificates	175,000	174,303
Subtotal	2,612,112	2,376,316

Nonmarketable securities:		
Special Treasury bonds	140,354,849	140,354,849
Federal Financing bonds	14,999,990	14,999,990
Certificates of Indebtedness	18,956,296	18,956,296
Subtotal	174,311,135	174,311,135
Total investments	$176,923,247	$176,687,451

3. The total benefits paid to participants by the Fund for fiscal year ending September 30, 1986 (including payments and refunds) was $24,636,476,000.

4. The total benefits paid to participants by the Fund for fiscal year ending September 30, 1987 (including payments and refunds) was $25,720,012,000.

5. The total interest income earned by the Fund for fiscal year ending September 30, 1986 was $15,121,237,000. The total interest income earned by the Fund for fiscal year ending September 30, 1987 was $16,121,768,000.

6. For fiscal years ending September 30, 1986 and September 30, 1987, the above total interest income amounts include interest in an amount not known to the parties earned from GNMA obligations which are not United States Securities and for which the Retirees claim no state tax exemption. For fiscal years ending September 30, 1986 and 1987, the Fund's GNMA certificates constituted approximately .1% of the Fund's investment portfolio.

The total interest income numbers for fiscal years ending September 30, 1986, and September 30, 1987 in the above paragraph include payments by the Treasury pursuant to special laws to compensate the Fund for income it could not earn because of the Fund's inability to invest its entire available cash balance due to the statutory debt limitations. For fiscal year ending September 30, 1986, the Fund was credited with an amount of approximately $77.8 million which constitutes approximately .51% of the Fund's total interest income. For fiscal year ending September 30,

1987, the Fund was credited with an amount of approximately $20.2 million which constitutes approximately .13% of the Fund's total interest income.

7. Based upon the Fund's annual reports, the total interest earned by the Fund expressed as a percent of total benefits paid to participants was approximately 61.4% in fiscal year 1986.

8. Based upon the Fund's annual reports the total interest earned by the Fund expressed as a percent of total benefits paid to participants was approximately 62.7% in fiscal year 1987.

9. Based upon the Fund's annual report for fiscal 1986, the total interest earned by the Fund expressed as a percent of total additions to the Fund is approximately 35.9% and the total interest earned by the Fund expressed as a percent of total assets of the Fund at the beginning of the fiscal year is approximately 10.9% and as a percent of the total assets of the Fund at the close of the fiscal year is approximately 9.6%.

Based upon the Fund's annual report for fiscal 1987, the total interest earned by the Fund expressed as a percent of total additions to the Fund is approximately 36.9% and the total interest earned by the Fund expressed as a percent of total assets of the Fund at the begining of the fiscal year is approximately 9.6% and as a percent of the total assets of the Fund at the close of the fiscal year is approximately 8.8%.

10. The following documents are attached and made a part of this Stipulation:

a. Plaintiff Meunier's 1986 Minnesota income tax return, his amended return and the related order.
b. Plaintiff Miller's 1986 Minnesota income tax return, his amended return and the related order.
c. Plaintiff Garin's 1986 Minnesota income tax return, his amended return and the related order.
d. Civil Service Retirement and Disability Fund Annual Report for fiscal year ending September

30, 1986.

e. Civil Service Retirement and Disability Fund Annual Report for fiscal year ending September 30, 1987.

Dated: February 28, 1992.

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Loren D. and Renetta J KEYS

v.

VERMONT DEPARTMENT OF TAXES.

No. 85-531.

Supreme Court of Vermont.

Dec. 24, 1988.

State appealed from determination of the Superior Court, Windsor County, finding that interest earned by taxpayer on investment in retirement plan was exempt from state taxation. The Supreme Court held that interest earned by taxpayer on investment in retirement plan fund which invested solely in federal obligations was income derived from federal obligations and as such exempt from state taxation.

Affirmed.

Taxation 1048

Interest earned by taxpayer on investment in retirement fund which invested solely in federal obligations was income derived from federal obligations and as such, was exempt from state taxation. 31 U.S.C.A. § 3124(a).

ENTRY ORDER

The State stipulates that the lump sum payment received by the taxpayer represents income derived from his investment in a retirement fund which invests

solely in federal obligations. The prospectus for the retirement plan containing the fund shows that the taxpayer elected to invest in that fund as one of five options and that his selection was made to ensure that, once placed in the fund, the money he invested could only be invested in federal obligations. Interest earned by the taxpayer on that investment must be characterized as income derived from federal obligations and as exempt from state taxation by 31 U.S.C. § 3124(a). See *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 862-63, 103 S.Ct. 3369, 3374-75, 77 L.Ed.2d 1072 (1983). The State's attempts to characterize the income otherwise are unavailing. See *In re Sawyer Estate*, 149 Vt. 541, 544, 546 A.2d 784, 785-86 (1987).

AFFIRMED.

State of Vermont

WINDSOR COUNTY, SS.

LOREN D. KEYS AND RENETTA J. KEYS	
	WINDSOR SUPERIOR COURT
v.	
	DOCKET NO. S11-83-WrM
VERMONT DEPARTMENT OF TAXES	

NOTICE OF DECISION

This case came before the Court on appeal, pursuant to 32 V.S.A. § 5885(b) and V.R.C.P. 74(a), from a decision of Vermont Commissioner of Taxes, after a formal hearing, upholding the Department of Taxes assessment of taxpayers' Vermont personal income tax for calendar year 1981. The issue presented on appeal is whether the Commissioner erred in her determination that a lump sum distribution received by taxpayers from the Savings Incentive Plan of Bankers Trust New York Corporation (the Plan) was subject to Vermont income tax, to the extent that the distribution constituted income received by the Plan from interest on United States Government obligations.

The Commissioner's Findings of Fact are not contested. In 1981, Mr. Keys, upon his retirement, received a lump sum distribution of $141,000 from the Savings Incentive Plan of Bankers Trust New York Corporation (the Plan). Of that distribution, $35,000 represented income from interest on United States Government obligations received by the Plan from its investments. Following a hearing before this Court the parties stipulated as follows: 1) The prospectus for the

Plan, admitted into evidence as Exhibit G in the hearing before the Commissioner of Taxes, accurately described the Plan; and 2) The Plan was a defined contribution savings plan, which, according to the prospectus, is qualified under Section 401 of the Internal Revenue Code of 1954, as amended by the Employment Retirement Income Security Act of 1974. Both parties agree, and the Commissioner found, that if the $35,000 distribution to taxpayers constituted non-taxable income, taxpayers are due a tax refund of $203.00, plus interest. If, however, the $35,000 distribution was taxable by the State, the taxpayers owed additional tax of $1,246.00, plus interest.

DISCUSSION

Review in Superior Court is an appellate review of the record made before the Commissioner of Taxes. *Vermont Department of Taxes v. Tri-State Industrial Laundries, Inc.*, 138 Vt. 292, 298 (1980). Findings of an agency in support of its action will not be set aside unless clearly erroneous. *In re Troyse*, 142 Vt. 612, 616 (1983). This Court, however, must assess independently the Commissioner's conclusions of law. *See American National Bank of Austin v. U.S.*, 421 F.2d 442, 451, *cert. denied* 400 U.S. 819 (1970).

Taxpayers claim that because $35,000 received from the Plan represented interest on U.S. Government obligations, the United States Constitution and federal law prohibits Vermont taxation of this income. Taxpayers rely on 31 U.S.C. § 742* (now codified as 31 U.S.C. § 3124, effective 1982) which prohibits taxation by a state of U.S. Government obligations. The exemption applies broadly to:

> every form of taxation that would require that

---

* Because the State tax in issue here was levied in 1981, the former Rev. Stat. § codified at 31 U.S.C. § 741, rather than 31 U.S.C. § 3124(a), technically controls this cost.

> either the obligations, or interest thereon, or both, be considered, directly or indirectly, in computing a tax . . . .

31 V.S.A. § 724(a). The statute specifically excludes from exemption estate and inheritance taxes and non-discriminatory franchise or other non-property taxes. 31 U.S.C. § 742(a)(1) and (2).

The above limitation on a state's taxing power is not technically an "exemption," but rather an "immunity" from taxation, based on the constitutional power of the United States Government to borrow money on credit of the United States, and the Supremacy Clause. *See U.S. Constitution*, Article I, § 8 and Article IV, Clause 2; *Weston v. City Council of Charleston*, 2 Pet. 449 (1829). As the U.S. Supreme Court has reasoned:

> A state tax, however small, upon such securities or interest derived therefrom, interferes or tends to interfere with the constitutional power to borrow money on the credit of the United States, and constitutes a burden upon the operations of government, and carried far enough would prove destructive. *Macallen Co. v. Commonwealth of Massachusetts*, 279 U.S. 620 (1929).

Accordingly, 31 U.S.C. § 742(a) merely codified this constitutional immunity; Supreme Court decisions have treated Section 742(a) as principally a restatement of the constitutional rule. *Memphis Bank & Trust Co. v. Garner*, 103 S.Ct. 692, 697 (1983), citing *New Jersey Realty Titlke Inc. Co. v. Division of Tax Appeals*, 338 U.S. 666, 672 (1950). Its purpose is "to prevent taxes which diminish in the slightest degree the market value or the investment attractiveness of obligations issued by the United States in an effort to secure necessary credit." *New Jersey Realty Title Insurance Co., supra*, at 675, citing *Smith v. Davis*, 324 U.S. 111, 117 (1944).

The State counters taxpayers' claim with the argument that immunity from state taxation of interest earned on federal obligations belonged to the Plan upon

receipt of that interest, not to taxpayers upon distribution of same. The interest received by the Plan lost its character as federal interest when it left the hands of the recipient (the Plan) and was distributed to taxpayers.

The State analogizes taxpayers' claim to that of a business which pays salaries with money derived from investments in U.S. obligations. While the business was exempt from state taxation of this money, the employees' salaries are not exempt from state taxation. The Commissioner based her determination, in part, on this reasoning, concluding:

> There is no principle of constitutional law which says that income which originates as interest on U.S. Government obligations is exempt for so long as the specific money can be traced. The Department's example, cited above, of the employer who pays his employees' wages with such interest is a common-sense example of the fact that the taxpayer's argument in this regard is not correct.

In re Keys, Personal Income Tax, Appeal No. ATC-83-6 at 4-5 (June 20, 1985).

Such a specious analogy does not assist this Court's determination of whether the particular state tax assessed is constitutionally permissible. Taxpayers have not claimed that tax-exempt income is tax-free "so long as it can be traced." Moreover, the analogy is not factually similar to this case. The Plan is not a business entity subject to federal income taxation. In fact, income earned by the Plan with funds held in trust is subject to neither federal income taxation, *see* I.R.C. § 401 and § 301(a), nor state income taxation by New York, the situs of the Plan. *See* N.Y. Tax Law § 601(d) (McKinney) (a trust exempt from federal income tax is also exempt from New York State income taxation).

The State further asserts that interest on U.S. Government obligations is exempt only in the hands of

the original recipient, unless there is a specific federal statute to pass through the tax-exempt character of such income. The Commissioner embraced this assertion and concluded:

> Interest on U.S. Government obligations is exempt from state taxation only in the hands of the original recipient. It requires a specific federal statute to pass through the tax-exempt character of such income to a taxpayer other than the original recipient. See, as examples of such statutes, Sections 652(b), 661(b), and 852 of the Internal Revenue Code. No federal statute authorizes a pass-through of exempt-character on distributions of this kind from an employee trust.

ID. at 4.

This conclusion is fallacious. The only "specific federal statute" which controls the issue presented is 31 U.S.C. § 742(a). The Internal Revenue Code, Sections 652(b), 661(b) and 852, regulate federal income taxation, not state income taxation. The Code is obviously silent on the issue of state taxation of federal obligations and interest derived thereon because such obligations and interest are 100% taxable by the federal government. The absence of an I.R.C. section specifying a pass through of the tax-exempt character of income distributed by a § 401 employee trust for purposes of *state* taxation is, therefore, not dispositive.

The Code sections referred to in the Commissioner's conclusions, I.R.C. §§ 652(b), 661(b) and 852, determine the tax-exempt status of interest income earned on state and municipal obligations under I.R.C. § 103(a)(1). This exemption is distinctly different from the constitutional and statutory immunity from state taxation of interest income earned on federal obligations. The statutory exemption from federal income taxation of interest on state or municipal obligations, I.R.C. § 103(a)(1), is an act of grace, not of constitutional necessity. Therefore, Section 103(a)(1) exemptions must be narrowly

construed. *American National Bank of Austin*, *supra*, at 451.

In contrast with the principle of tax immunity, where the power to tax is absent, relinquishment of the power to tax cannot be presumed; exemptions must be in clear and unmistakable terms. For this reason, specific sections of the Internal Revenue Code authorize a passthrough of the tax exempt character of Section 103(a)(1) income. Without such authorization, no exemption is granted. For example, distributions from exempt § 401 employees' trusts cannot qualify as tax exempt interest under I.R.C. § 103(a)(1). *See* Rev. Rul. 55-61, 1 C.B. 40 (1955) (taxation of § 401 trust distributions governed by the liberal provisions of §§ 402 and 403); acord *rev. Rul.* 72-99, 1 C.B. 115 (1972) (cash dividends distributed by §401 trust not exempt under the provisions of I.R.C. § 116).

The State's reliance on *Woodroof v. Tax Commissioner*, 440 A.2d 854 (Ct. 981), for the proposition that interest derived from U.S. Government obligations does not retain that character upon distribution from a § 401 trust, is misplaced. *See* Vermont Department of Taxes, *Memorandum of Law*, Docket No. S11-83-WrM, at 6. The court in *Woodruff* considered a taxpayer's claim that a distribution from a regulated investment company (mutual fund) was tax-exempt interest for purposes of state taxation. Under federal law, a regulated investment company is qualified to pay exempt interest dividends only if at least fifty percent of the value of the total assets of the company consists of tax exempt obligations. *See* I.R.C. § 852(b)(5). The taxpayer did not claim that the distribution they received qualified as tax-exempt interest dividends under I.R.C. § 852(b)(5), and therefore, the interest income of the investment company did not flow through to the taxpayer for purposes of the federal tax exemption under I.R.C. § 103(a)(1). *Woodruff*, *supra*, at 856-57. Because the scheme of state taxation

incorporated the federal tax scheme for taxation of dividends, the court held that the distribution of tax-exempt interest received by the investment company was taxable by the state.

The court in *Woodruff* was considering state taxation of interest derived from state obligations, not from U.S. obligations. Such interest is fully taxable by both state and federal governments absent a specific statute exempting the income from taxation. Therefore, the character of such interest received by the investment company did not flow through to the taxpayer; the specific statutory requirement for such exemption was not met.

In contrast with federal tax exemptions, where taxation is the rule and an exemption is the exception, the language of 31 U.S.C. § 742 is "inconsistent with implied exceptions" to the statutory rule prohibiting state taxation. *American Bank and Trust Co. v. Dallas County*, 103 S.Ct. 3369, 3375 (1983). The principle of broad immunity from state taxation given federal obligations and interest thereon is clearly demonstrated in the recent Supreme Court decision cited above. The Court in *American Bank & Trust Co. v. Dallas County* disallowed a property tax imposed by Texas on bank shares. In computing the value of each share the state considered the value of U.S. obligations held by banks. The Court recognized that prior to a 1959 amendment to Rev. Stat. § 3701, 31 U.S.C. § 742, it had permitted states to impose taxes on corporate shares even when the value of that interest was measured by underlying United States obligations, a practice "firmly embedded in the law." *Id.* at 3372, citing *Society for Savings v. Bowers*, 349 U.S. 143, 148 (1955). This formalistic approach to 31 U.S.C. § 742 was based on the theory that a tax on a stockholder's interest or transaction separate from the ownership of federal obligations is not a tax on the federal obligations which are included in the corporate property because it was assessed on a discreet interest separate from the federal obligations.

Id. at 3379.

American Bank & Trust rejected this earlier approach, reasoning that Congress, by amending 31 U.S.C. § 742, "intended to sweep away formal distinctions and to invalidate all taxes measured directly or indirectly by the value of federal obligations, except those specified in the amendment." *Id.* at 3377. The Court, in light of the plain language of 31 U.S.C. § 742, held that the tax on bank shares takes into account, at least indirectly, the federal obligations that constitute a part of the bank's assets and therefore violated the statute. *Id.* at 3374.

Although *American Bank & Trust Co. v. Dallas County* does not directly address the issue raised by this appeal, it is helpful. This case clarifies the necessary approach for purposes of deciding this appeal. *American Bank & Trust Co.* began its analysis of the issue with a consideration of the true nature of the state tax assessment in relation to the clear meaning of 31 U.S.C. § 742, which controlled the discussion. Furthermore, formal distinctions were ignored; given the broad scope of 31 U.S.C. § 742, which codified the constitutional immunity from state taxation, the presumption was against state taxation and no exceptions were implied. This Court's inquiry, therefore, is narrowed to whether, in practical operation and effect, Vermont's income tax assessment is, in part, a tax upon interest derived from federal securities. Where a federal right is concerned, we are not bound by the characterization given to the state tax by the Commissioner, "or relieved by it from the duty of considering the real nature of the tax and its effect upon the federal right asserted." *Society for Savings v. Bowers*, *supra*, at 152, citing *Carpenter v. Shaw*, 380 U.S. 363, 367 (1930).

Taxpayers' income, at issue here, was received in the form of a lump sum distribution from a qualified § 401 savings incentive plan established by Banker's Trust New York Corporation for the benefit of its employees.

The Plan was a tax-exempt entity under the provisions of I.R.C. § 501(a), not a separate tax entity as asserted by the State. *See* Vermont Department of Taxes, *Memorandum of Law*, *supra*, at 7. The Plan was one which used a trust to invest the funds contributed by both employers and employees and to distribute the benfits to participants or their beneficiaries. *Prospectus*, at 10-13. This enabled Mr. Keys to save and invest a percentage of his salary tax free until distribution; the income and earnings thereon were not taxed until these amounts were distributed to him, allowing a deferral of both state and federal taxation. *See* I.R.C. §§ 402 and 403.

The amounts contributed by both employer and Mr. Keys were invested in one or more funds at the election of, and in proportions designated by Mr. Keys. *Prospectus*, at 1 and 12. One such fund, Fund (A), was a fund together with the earnings thereon, invested in federal obligations. *Prospectus*, at 10. The $35,000 at issue here was interest on earned contributions attributed to Mr. Keys and invested in Fund (A). The trustee maintained a separate account for Mr. Keys, with separate records for his share in each of the funds selected by him. *Prospectus*, at 4. The investment performance of the five funds over a five year period from 1975-1979, was presented in the prospectus. *Prospectus*, at 13.

In essence, the Plan provided Mr. Keys an investment scheme whereby he could invest tax-free a portion of his otherwise taxable income in a choice of five investment portfolios. The character of the trust assets attributed to Mr. Keys account was irrelevant, prior to distribution, for purposes of federal and state taxation; the trust per se, as a tax-exempt entity, received no benefit from any tax-exempt or immune interest earned on investments. All incidence of income taxation, both federal and state, commenced upon taxpayers' receipt of the income.

The only substantial difference between Mr. Keys investing personally in federal securities, whose interest

would be immune from state income taxation, and the transaction in question, is that the Plan grants Mr. Keys a congressionally approved method whereby both the use of and tax upon the income is deferred. Mr. Keys, not the Plan, decided to invest a portion of his contributions in federal obligations. Mr. Keys, not the Plan, was the recipient of the first tax assessment on the interest earned on these federal obligations. An assessment of state income tax on that portion of the distribution was, in reality, a direct tax on interest derived from federal obligations prohibited by 31 U.S.C. § 724.

The principles underlying federal taxation of common-law trusts further assist this Court in its duty to consider the true nature of the tax and bolster its conclusion that the assessed tax is illegal. Income from trust property is taxed either to the trust or its beneficiaries as determined by rules found in I.R.C. §§ 651-668. These rules are premised on the principle that a trust is a conduit through which income can pass untaxed and unchanged in character until it reaches actual beneficiaries. I.R.C. §§ 652(b), 661(b), 662(b). Simply stated, the income paid out to beneficiaries is taxed just once, and taxed to the beneficiaries, not the trust. I.R.C. §§ 652, 662. The rules also insure that income will be treated as the same in form to the beneficiary as received by the trust. I.R.C. §§ 652(b) and 661(b).

The Commissioner concluded that only interest from governmental obligations earned by common-law trusts is immune from taxation because the pass-through of the exempt character of such common-law trust income is authorized by I.R.C. §§ 652(b) and 661(b). *In re Keys*, *supra*, at 4. As noted earlier the absence of a federal revenue statute authorizing the pass-through of income unchanged in character is not relevant for purposes of analyzing a state tax under the provisions of 31 U.S.C. § 742(a). No other reason is given to support the Commissioner's conclusion.

Given the expansive scope of constitutional and statutory immunity from state taxation of interest derived from federal obligations, this Court finds no substantial factual basis nor any legal basis for making a distinction between a common-law trust governed by Subchapter J of the Internal Revenue Code and an employee trust, such as the Plan, governed by Subchapter D of the Internal Revenue Code, for purposes of determining the character of income received by taxpayers under the provisions of 31 U.S.C. § 742(b). The principles of taxation applicable to common-law trusts should apply equally to the Plan.

Congress determined that the conduit principle underlying common-law trusts should apply to a § 401 trust, granting tax-exempt status to such trusts, taxing only the beneficiaries of the trust. *See* I.R.C. §§ 401 and 402. The statutory framework of a § 401 employee trust is analagous to a common-law simple trust. As in a simple trust, a § 401 trust is not subject to tax; only the beneficiaries are taxed on income earned by trust assets. *See* I.R.C. §§ 651 and 652. Under accepted principles of trust-taxation, therefore, interest on federal obligations is immune from state taxation, not in the hands of the original recipient, but in the hands of the recipient who is first taxed on that income, in this case, taxpayers. In practical operation, the tax in question was in fact a state tax on interest derived from federal obligations.

A construction of the constitutional principle underlying the state tax immunity codified in 31 U.S.C. § 742(a) does not depend on the weight of the burden or degree of interference with the constitutional power to borrow money on credit of the United States. *See Macallen Co. v. Commonwealth*, *supra*; *New Jersey Realty Title Ins. Co.*, *supra*. The state tax assessment at issue in this case could diminish the investment attractiveness of federal obligations, offered in Fund (A) of the Plan. Although one reason Mr. Keys might have elected to invest in Fund (A) was for investment

security, another plausible reason was for state tax benefits. The state tax in issue could interfere with this constitutional power, if only slightly. It was, therefore, unconsitutional. *See New Jersey Realty Title Ins. Co., supra*, at 675 (statute's purpose to prevent taxes which diminish in "slightest degree" investment attractiveness of federal oblitations).

For all the foregoing reasons, this Court vacates the Commissioner's determination and orders Vermont State Department of Taxes refund to Plaintiff $203.00 plus interest.

Date at Woodstock, County of Windsor and State of Vermont, this 21st day of November, 1985.

s/s

MATTHEW I. KATZ
SUPERIOR COURT JUDGE

Supreme Court, U.S.
F I L E D
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OFFICE OF THE CLERK

No. 93-627

In The

Supreme Court of the United States

October Term, 1993

ROBERT E. MEUNIER, EARL W. MILLER, and EDWARD GARIN,

Petitioners,

v.

MINNESOTA DEPARTMENT OF REVENUE, and DOROTHY A. McCLUNG, in her capacity as Minnesota Commissioner of Revenue,

Respondents.

On Petition For Writ Of Certiorari To The Minnesota Supreme Court

BRIEF IN OPPOSITION

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QUESTIONS PRESENTED

Does 31 U.S.C. § 3124(a) (1988) exempt from state taxation some portion of the annuity payments received by a federal retiree from the Civil Service Retirement and Disability Fund ("the Fund") merely because the Fund invests in U.S. Government obligations and receives interest thereon?

Does state taxation of annuity payments from the Fund violate the doctrine of intergovernmental tax immunity where similar distributions from state and private pension funds are similarly taxed?

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OPINIONS BELOW

The opinion of the Minnesota Supreme Court in this case is reported at 503 N.W.2d 125. That opinion and the unpublished opinion of the Minnesota District Court are reproduced in the Appendix to the Petition.

STATEMENT OF THE CASE

Respondents disagree with Petitioners' Statement of the Case because Petitioners have omitted the uncontroverted facts presented by Respondents' expert witnesses in addition to the stipulation.

Petitioners are three retired federal employees who each received annuity payments from the Civil Service Retirement and Disability Fund (hereinafter "Fund") in 1986. Each paid Minnesota income tax on the annuity payments he received. Subsequently, each filed a claim for refund of the Minnesota income tax paid, claiming that the annuity payments received were partially exempt from state taxation under 31 U.S.C. § 3124(a) (1988). The Minnesota Department of Revenue denied the claims and this refund action resulted.

The Fund was established by Congress in 1920. It is a separate account within the U.S. Treasury. *See* 5 U.S.C. §§ 8331(18) and 8348 (1988). Its functions are to receive contributions from federal employees, employing agencies, and the U.S. Treasury; receive income from investments; pay administrative expenses; and pay benefits,

primarily annuity payments, to retired and disabled federal employees and their survivors. Lodg. 8; App. C-4.[1]

The Fund is the account for two defined benefit retirement plans established for federal employees under federal law. These plans, the Civil Service Retirement System (CSRS) and the Federal Employees Retirement System (FERS), are administered by the Office of Personnel Management. 5 U.S.C. § 8347 (1988); Lodg. 2, 3, 8. Under these defined benefit plans, a retiree receives a certain defined stream of benefit payments which is determined by his length of service and salary level. Lodg. 10, 11, 31; App. C-5; S.App. 3. A retiree's benefit is not dependent upon the amount of his contribution or the income earned by the Fund. Lodg. 10, 11, 31; S.App. 3. The benefits paid arise from and are in consideration for the retiree's prior employment. S.App. 3-4, 6.

Additions to the Fund come from mandatory withholding from current federal employees, mandatory contributions from federal agencies, appropriations from the general fund of the U.S. Treasury, and investment income from United States Government securities (primarily nonmarketable securities with maturities fitting the Fund's needs and with interest rates based upon the average market yield of outstanding marketable securities) or from securities guaranteed by the United States; 5 U.S.C. § 8348(d) and (e) (1988); Lodg. 29, 37.

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[1] Petitioners' Appendix is abbreviated "App." and their Lodging "Lodg.". Respondents' Supplemental Appendix is abbreviated "S.App.".

The Fund is not designed as a "pass through" entity in which ownership and rights of ownership of the assets are passed to the participants. S.App. 3. It is not possible to determine the share of the Fund attributable to any retiree or unretired participant. S.App. 3, 7. There is no sense in which retirees or unretired participants in the plan are owners of U.S. Government securities or may be said to be receiving interest on U.S. Government securities. S.App. 3, 6.

For federal income tax purposes, the Fund is treated like a qualified pension plan trust under 26 U.S.C. § 401(a) (1988) that is exempt from income tax under 26 U.S.C. § 501(a) (1988). The payments received by a retiree are subject to federal income tax under 26 U.S.C. § 72 (1988). Under § 72, payments received by each retiree-Petitioner prior to the years in question were excluded from his federal gross income until each Petitioner had received an amount equal to his contributions to the Fund (on which he had already paid income tax). Thus each Petitioner recovered his "cost" or "basis" in his annuity. Thereafter all annuity payments received are taxed as ordinary income. App. C-5. Minnesota has adopted the foregoing income tax treatment as well. Minn. Stat. § 290.01, subd. 20 (1986).

The Minnesota tax on the annuity benefits of retirees is the same for all public and private pensions. Minn. Stat. § 290.01, subd. 20 (1986). The Minnesota tax is not dependent upon or computed with respect to the income, if any, received by the Fund. App. A-6 & 7. The imposition of Minnesota income taxes on annuity payments received from the Fund by retirees, disabled persons, and survivors does not increase the cost to the United States

of borrowing money nor does it diminish to any degree the market value or investment attractiveness of United States Government obligations. S.App. 2-3.

REASONS FOR DENYING THE PETITION

There is no reason for the Court to review this case. The Minnesota Supreme Court decided the matter correctly, following established legal principles. The decision below neither deviates from nor conflicts with governing statutes nor with judicial decisions. Moreover, the primary conflict claimed by Petitioners is with a one-paragraph decision of the Vermont Supreme Court affirming an unpublished lower court decision. Even if the Court were concerned that the issues presented might warrant further review, it would be prudent to allow additional courts the opportunity to analyze them. Then this Court's review, if necessary, would be fully informed by that additional scrutiny.

I. THE MINNESOTA SUPREME COURT'S DECISION DOES NOT CONFLICT WITH OTHER DECISIONS APPLYING 31 U.S.C. § 3124(a) (1988) BECAUSE THE MINNESOTA INCOME TAX DOES NOT REQUIRE THE INTEREST ON U.S. OBLIGATIONS TO BE CONSIDERED IN COMPUTING THE TAX.

The tax exemption for federal obligations is codified in 31 U.S.C. § 3124(a) (1988):

> Stocks and obligations of the United States are exempt from taxation by a State or political subdivision of a State. The exemption applies to

> each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax, except – (1) a nondiscriminatory franchise tax or other nonproperty tax instead of a franchise tax, imposed on a corporation; and (2) an estate or inheritance tax.

The statutory exemption has historically been treated as principally a restatement of the constitutional immunity for U.S. Government securities. *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392 (1983); *First National Bank of Atlanta v. Bartow County Bd.*, 470 U.S. 583 (1985). However, this Court has more recently made it clear that the statutory exemption is greater than that required by the Constitution. Absent the statute, states could constitutionally tax a holder of government bonds on bond interest, just as states can tax other private parties doing business with the United States, provided the tax does not discriminate against the United States or those with whom it deals. *South Carolina v. Baker*, 485 U.S. 505, 523, 526 (1988).[2]

As explained in the following sections, the Minnesota Supreme Court's decision in this case does not conflict with other decisions applying 31 U.S.C. § 3124(a) (1988). It does not conflict because the Minnesota income tax does not require the interest on U.S. obligations to be considered in computing the tax. The Minnesota decision is therefore consistent with *American Bank & Trust Co. v. Dallas County*, 463 U.S 855 (1983) and is distinguishable

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[2] The Petition at page 20 incorrectly states that the statutory exemption is constitutionally mandated.

from the state court decisions relied upon by Petitioners. In addition, the decision of the Vermont Supreme Court in *Keys v. Vermont Department of Taxes*, 552 A.2d 418 (Vt. 1987), *cert. denied*, 485 U.S. 1035 (1988) is distinguishable because that case did not involve state taxation of compensation paid for services by a defined benefit plan like the Fund, but rather involved state taxation of U.S. obligation interest earned on an investment in U.S. obligations. Decisions concerning regulated investment companies are distinguishable because the Civil Service Retirement and Disability Fund is not a conduit for investment in federal obligations as are regulated investment companies.

A. The Minnesota Supreme Court's Decision In This Case Does Not Conflict With This Court's Decision In *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855 (1983), Because Interest On U.S. Obligations Is Not Taken Into Account In Computing The Minnesota Tax.

The decision of the Minnesota Supreme Court in this case does not conflict with this Court's application of 31 U.S.C. § 3124(a) (1988) in *American Bank*. *American Bank* considered the validity of a property tax imposed on bank shares. However, the tax was computed on the bank's net assets, which included the value of U.S. obligations held by the bank. *American Bank*, 463 U.S. at 856. The practical impact of the tax was indistinguishable from that of a tax imposed directly on the bank's assets, including the U.S. obligations. *Id.* at 862.

Prior to amendment of the exemption in 1959, a formalistic but economically meaningless distinction

between taxes on U.S. Government obligations and taxes on separate interests had permitted taxes to be computed on a bank's assets, including U.S. obligations, so long as the taxes were imposed on the bank shares and not directly on the U.S. obligations. *Id.* at 858. This formalism had been criticized as resting upon a distinction of words without substance. *Id.* at 866. This Court specifically recognized that the 1959 amendment to the exemption "rejected and set aside" that "rather formalistic pre-1959 approach to [the exemption]." *Id.* at 862.

In *American Bank* this Court examined the tax to determine whether U.S. obligations were "considered . . . in computing the tax." *Id.* To determine whether U.S. obligations were "considered" in computing the tax, the Court looked at whether the U.S. obligations were "taken into account or included in the accounting" in computing the tax. *Id.* The bank shares tax was computed on the bank's net capital assets, including the U.S. obligations. If the bank's assets increased, the tax increased, even though the additional assets were all U.S. obligations. This Court held that such a computation plainly took the U.S. obligations into account, at least indirectly, in violation of the exemption. *Id.* at 862-63.

The Minnesota Supreme Court applied the exemption just as this Court did in *American Bank*. Application of the *American Bank* test establishes that Minnesota's tax on the annuity payments received by retirees does *not* violate the exemption. The Minnesota tax is computed on the annuity payments received by the retiree without any consideration of the interest, if any, of the Fund. Because each retiree received a fixed annuity based only upon his years of service and the amount of his salary before

retirement (Lodg. 11; App. C-5) the amount of the annuity payments received is completely unaffected by any interest income that the Fund may, or may not, have. *See* S.App. 3. Thus, the annuity receipts and Minnesota's tax on them are wholly independent from and unaffected by the Fund's income. *See* App. A-6, A-7. Because Minnesota's income tax on retirees' annuity receipts is wholly independent from and unaffected by the Fund's income, or lack of income, the Fund's U.S. obligation income is not taken into account in computing the tax.

Accordingly the Minnesota Supreme Court found that "neither the amount of the annuity payments nor the amount of the Minnesota tax is measured by or computed on or dependent in any way on the amount of interest received by the Fund by reason of its ownership of U.S. securities." App. A-6. It concluded that "the tax is neither computed on nor measured by, either directly or indirectly, the amount of income realized by the Fund from U.S. securities."[3] App. A-7. This analysis and decision is

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[3] Reference to the "measure" of the tax recalls the Idaho tax which was the catalyst for the 1959 amendment to the exemption. Idaho imposed a tax "upon every individual . . . which shall be according to and measured by his net income" including income from U.S. obligations. Idaho's position was that its tax need not exempt interest received on federal obligations because the tax was imposed on the individual and was merely measured by his net income. *American Bank*, 463 U.S. at 865. "Congress intended [the 1959 amendment] to abolish the formalistic distinction between taxes *on* income and taxes *measured* by income that underlay Idaho's arguments." *First National Bank of Atlanta v. Bartow County Bd.*, 470 U.S. 583, 594 (1985). Contrary to the statement at page 19 of the Petition that the Minnesota Supreme Court decision is based upon the "formalistic distinc-

entirely consistent with this Court's analysis and decision in *American Bank*.

The complete separation of the tax from the Fund's U.S. obligation interest income is readily seen by hypothesizing changes in the Fund's U.S. interest income. If that income were twice as great, the annuities would nevertheless remain the same because they are based on years of service and highest salary. Minnesota's income tax on the retirees' annuity income would remain the same. Where, as in this case, there is no relationship at all between the amount of the tax and the U.S. obligation income, upholding the tax cannot in any way be said to conflict with this Court's decision in *American Bank*.

B. The Minnesota Supreme Court's Decision In This Case Does Not Conflict With The Vermont Supreme Court's Decision In *Keys v. Vermont Department Of Taxes*, 552 A.2d 418 (Vt. 1987), *cert. denied*, 485 U.S. 1035 (1988), Because *Keys* Did Not Involve A Tax On Compensation Paid Under A Defined Benefit Plan, But Rather Involved A Tax On U.S. Interest Paid In Addition To Compensation Under A Defined Contribution Plan.

The *Keys* decision is a one-paragraph order affirming the unpublished opinion of the Windsor County Vermont Superior Court in a dispute involving $1,449. App. D, E-2.

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tions" that have been invalidated by this Court, the Minnesota Supreme Court has made it clear that its decision is not so based.

Although *Keys* was decided in 1987, until it was distinguished by the Minnesota Supreme Court in this case, it had not been relied upon or even cited in a reported decision.

Unlike the detailed information that we have in this case, we know little about the Savings Incentive Plan of Bankers Trust New York Corporation which was involved in *Keys*. While the Windsor County Court decision refers to and had the benefit of a prospectus and a stipulation, Petitioners did not provide that information, even though they have urged that *Keys* should be followed and even though they had the burden of proof and persuasion.

Although we lack detailed information, *Keys* is distinguishable from this case. The first distinction between the cases is the nature of the payments that were received by the taxpayers. In this case, the payments which Petitioners received were deferred compensation for services previously rendered by Petitioners. In contrast, the payment that was in question in *Keys* was not compensation for services but was interest earned in addition to the compensation.

The retirement annuities that the Fund pays retirees and which are involved in this case are compensation for the retirees' past years of government service:

> We have no difficulty concluding that civil service retirement benefits [from the Civil Service Retirement and Disability Fund] are deferred compensation for past years of service rendered to the Government.

Davis v. Michigan Dep't of Treasury, 489 U.S. 803, 808 (1989); *accord Barker v. Kansas*, ___ U.S. ___, 112 S.Ct. 1619

(1992) (military retirement pay is deferred pay for past services). *See also* S.App. 3-4, 6.

Section 3124(a) does not exempt compensation paid to present or past federal employees from state income taxation. While compensation paid to federal employees was at one time held to be immune from state taxation, *New York ex rel. Rogers v. Graves*, 299 U.S. 401 (1937), that decision was specifically overruled two years later in *Graves v. New York ex rel. O'Keefe*, 306 U.S. 466 (1939). The states' right to tax compensation paid to federal employees on a nondiscriminatory basis was immediately thereafter embodied in statute:[4]

> The United States consents to the taxation of pay or compensation for personal service as an officer or employee of the United States . . . by a duly constituted taxing authority having jurisdiction, if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation.

4 U.S.C. § 111 (1988). The taxability of retirement benefits is further confirmed by *Davis*:

> [T]he overall meaning of 4 U.S.C. § 111 is unmistakable: *it waives whatever immunity* past and present federal employees would otherwise enjoy from state taxation of salaries, *retirement benefits, and other forms of compensation* paid on account of their employment with the Federal

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[4] Petitioners incorrectly state at page 25 of their Petition that "[p]rior to the adoption of 4 U.S.C. § 111, no state income taxation of federal employees was allowed."

> Government, except to the extent that such taxation discriminates on account of the source of the compensation.

489 U.S. at 810 (emphasis added).

Thus, this Court has expressly recognized that the payments in question in this case are payments to Petitioners of compensation for past services. Furthermore, Congress has expressly provided that the states may impose a non-discriminatory income tax on such compensation, as this Court acknowledged in *Davis*.

In contrast to this case, the payment in question in *Keys* was not compensation for past services. *Keys* involved interest "earned by" and paid to an individual taxpayer on his investment in the Savings Incentive Plan of Bankers Trust New York Corporation ("the Plan"), a defined contribution savings plan qualified under 26 U.S.C. § 401 (1988). App. D; E-1, 2. Pursuant to the taxpayer's direction, the compensation paid into the plan had been invested in U.S. obligations (App. D-2) and the amount in question was the interest earned on that investment (App. E-9). When the taxpayer received payment of a lump sum distribution from the Plan, the question was the taxability of that portion of the payment which was interest earned by the taxpayer on his investment. App. D-2. There was no question in *Keys* that the portion of the payment that represented compensation for his services was taxable. It is entirely payment of compensation for services that is subjected to tax in this case.

Thus, *Keys* is distinguishable because it involved the taxability of interest earned on the taxpayer's investment

in U.S. obligations while this case involves the taxation of compensation for past services.

The *Keys* decision is also distinguishable because, unlike this case, the Vermont tax was apparently computed on the amount of U.S. Government obligation interest which had been earned on the taxpayer's investment. The Vermont Court could thus conclude that under *American Bank* the tax violated § 3124(a) because the U.S. obligation interest was "taken into account or included in the accounting" in computing the tax. *American Bank*, 463 U.S. at 862. The Plan in *Keys* was a defined contribution plan (App. E-2) under which the taxpayer had a separate account and was entitled to receive the contributions to his account plus whatever was earned on those contributions. *See* App. E-9. An increase in the interest earned would have increased the amount paid to the taxpayer and the amount subject to tax. As previously discussed, there is no similar relationship between any income earned by the Fund and the Minnesota tax.

The *Keys* case is also distinguishable because in that case the U.S. obligation interest was separately credited to and became part of the individual taxpayer's separately owned account and was thus traceable to the taxpayer. The Minnesota Supreme Court noted this in its opinion. App. A-9. In contrast, in this case the U.S. obligation interest is not credited to any accounts and is not similarly traceable. The law provides simply that interest earned by the Fund becomes part of the Fund. 5 U.S.C. § 8348(c).

Unlike the taxpayer in *Keys*, Petitioners made and wanted the Minnesota courts to adopt numerous assumptions so they could compute an amount to claim as exempt. Petitioners did so even though none of their assumptions have any basis in fact. For example, Petitioners wanted the Minnesota courts to assume that the Fund's report for its fiscal year ending September 30, 1986, should be used to compute amounts for calendar 1986. There is no basis for such an assumption. Petitioners wanted the courts to assume that the interest earned by the Fund is not used to pay any of the Fund's administrative expense. This assumption is not only factually baseless, it is contrary to this Court's teaching in *First National Bank of Atlanta v. Bartow County Bd.*, 470 U.S. 583 (1985) that exempt U.S. obligations can be charged with their fair share of related expenses and burdens.

Petitioners wanted the Minnesota courts to assume that the Fund retained none of the interest earned, but paid out all interest in the year it was earned. Again, there is no basis for such an assumption. They also wanted the courts to assume that all payments made to beneficiaries throughout the year, even payments that were return of a beneficiary's basis, contained the same proportion of interest. This is yet another assumption for which there is no factual basis.

Petitioners' reliance on unfounded factual assumptions further shows the difference between this case and *Keys*.

For the foregoing reasons, the *Keys* decision is distinguishable and the decision of the Minnesota Supreme Court in this case does not conflict with it.

C. The Minnesota Supreme Court's Decision In This Case Does Not Conflict With Its Own Decision Or The Decisions Of Other State Courts Concerning The Tax Treatment Of Distributions From Regulated Investment Companies Because The Fund Is Not A Conduit For Investment In Federal Obligations.

The Minnesota Supreme Court, like other state courts which have addressed the issue, has held that dividends received from a regulated investment company (a mutual fund) are exempt from Minnesota income tax to the extent that the dividends are directly attributable to United States Treasury notes and bonds. *Yurista v. Commissioner of Revenue*, 460 N.W.2d 24 (Minn. 1990).[5] This case does not conflict with those decisions. Rather, those decisions serve to highlight the difference between the pension annuities which are the subject of this case and exempt U.S. interest.

The nature of regulated investment companies and their distributions to their shareholders are discussed in the cases from the various states and are well known. The securities and tax laws establish regulated investment companies as vehicles for investment in securities and currencies, and require such companies to so invest their shareholders' money. The laws also require regulated investment companies to annually report to each shareholder the result of his share of the investment and to distribute to each shareholder his share of the net income earned. Furthermore, within limits, the tax laws expressly

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[5] Cases from other jurisdictions are consistent with *Yurista* and are listed on page twenty of the Petition.

treat each shareholder-investor as though he directly earned a proportionate share of the income earned. 26 U.S.C. (Internal Revenue Code (I.R.C.)) §§ 851-855 (1988); *see Andras v. Illinois Department of Revenue*, 506 N.E.2d 439, 440 (Ill. App. Ct. 1987), *cert. denied*, 485 U.S. 960 (1988).

The particular characteristics given to regulated investment companies by the applicable statutes have led to their being described as "conduits" or "pass throughs" for investment income. The business of a regulated investment company is "to provide a conduit for investment" in securities. *Brown v. Franchise Tax Bd.*, 242 Cal. Rptr. 810, 813 (Cal. Ct. App. 1988). Securities owned as investments by a regulated investment company and the income from those securities have been recognized as being directly attributable to the shareholders because of the "conduit" or "pass through" characteristics statutorily given to regulated investment companies:

> The "earnings [of a regulated investment company] tend not to be regarded as their own, but as their shareholders". . . . For shareholders [of regulated investment companies], dividends are classified as ordinary, capital gain, exempt interest, or return of capital, depending on the type of earnings from which they [the dividends] are paid.

7 Stand. Fed. Tax Rep. 1991 (CCH) ¶ 26,633.01.

> A mutual fund [regulated investment company] is a pool of assets, consisting primarily of portfolio securities, and belonging to the individual investors holding shares in the fund.

Burks v. Lasker, 441 U.S. 471, 480 (1979).

Based upon the specific statutory characteristics of regulated investment companies, various state courts have determined that dividends from a regulated investment company which has invested in federal obligations are exempt from state taxation to the extent that they are attributable to interest earned on the federal obligations. As the Minnesota Supreme Court said, "the ability of a taxpayer to demonstrate with specificity a direct attribution of income to the tax-exempt federal obligations is sufficient to overcome any technical nomenclature." *Yurista*, 460 N.W.2d at 27.

Unlike a regulated investment company, the Civil Service Retirement and Disability Fund is not a "conduit" or "pass through" for investment, and the r irement annuities it pays to retirees have none of the characteristics of distributions from a regulated investment company. As discussed above in part I.B., the retirement annuities that the Fund pays to retirees are compensation for their past years of government service. The fact that the annuity payments are compensation for services and not interest is confirmed by uncontradicted experts who both concluded that the payments are for prior services and that it would be inappropriate to characterize any portion of Petitioners' retirement annuities as interest on U.S. Government obligations. S.App. 3, 4, 6. It is further confirmed by the fact that Petitioners could not have any investment balance in the Fund, having previously received more than they ever paid into the Fund. App. C-5.

Further, the ap licable statutes do not make the Fund a "conduit" or "pa through" entity. Petitioners use the

terms "pass through" and "conduit" without acknowledging that these are not statutory nor even precisely defined terms. These terms are short-hand labels used to refer to entities to which statutes have given particular tax characteristics similar to those of regulated investment companies described above. For example, partnerships are commonly described as "pass through" or "conduit" entities. Just as the relevant tax characteristics of regulated investment companies are found in 26 U.S.C. §§ 851-855 (1988), the relevant tax characteristics of partnerships are found in 26 U.S.C. (Internal Revenue Code (I.R.C.)) §§ 701-761 (1988). "S" corporations, estates, and simple trusts are also commonly called "pass through" or "conduit" entities. However, the particular statutorily defined characteristics of each of these entities is different from each other. 26 U.S.C. (I.R.C.) §§ 1361-1375 ("S" corporations), 641-692 (estates and trusts) (1988).

For tax purposes, the Fund is treated as a qualified pension plan trust (App. C-5) and so is given the specific characteristics provided by 5 U.S.C. §§ 8301 *et seq.* (1988) and 26 U.S.C. (I.R.C.) §§ 401, 402, 501 and 72 (1988). These provisions are adopted by Minnesota by Minn. Stat. §§ 290.01, subd. 19 and 290.05. subd. 2 (1986). Review of these provisions shows that the Fund lacks characteristics like those of regulated investment companies, partnerships, simple trusts and "S" corporations. While the Fund is tax exempt, the statutes do not provide that each Fund participant is treated as though he directly earned a proportionate share of the Fund's income. The Fund is not a "conduit" or "pass through."

The fact that the governing statutes do not give qualified pension plan trusts "conduit" or "pass through"

characteristics has long been recognized. In 1955, in a revenue ruling involving tax exempt interest, the Internal Revenue Service stated that a pension plan trust is not a "conduit" or "pass through" for interest that it receives:

> Although a distribution from an employees' trust meeting the requirements of section 401 of the Internal Revenue Code of 1954 is made in whole or in part from funds received by the trust as interest on tax-free securities, such distribution, when received or made available, is taxable income to the distributee in the manner and to the extent provided by section 402(a) of the Code.

Rev. Rul. 55-61, 1955 1 C.B. 40. This ruling stands as the unchallenged and accepted interpretation of the applicable statutes – a pension plan trust is *not* a "conduit" or "pass through." This is opposite the result that would obtain from a partnership, a simple trust, or a regulated investment company. It stands in direct contradiction to Petitioners' assertions.

Finally, the Fund is not a "conduit" or "pass through" in economic terms. The economist who reviewed the Fund concluded it was not a "pass through" entity, that it is not possible to determine an individual's share in the Fund, and that there is no sense in which participants may be said to be receiving interest from U.S. Government securities. S.App. 3; *see* S.App. 6, 7. Further, unlike distributions of income from regulated investment companies, payments to retirees from the Fund are not dependent upon nor do they increase or decrease depending upon the investment income of the fund. The two are entirely independent. App. C-4, C-5; S.App. 3.

From the foregoing, it is clear that the Fund is not a "conduit" or "pass-through" entity like a regulated investment company, and the retirement annuities the Fund pays to retired employees are very different from a regulated investment company's distributions to its shareholders. The Minnesota Supreme Court's decision in this case does not conflict with its own decision or the similar decisions of other state courts regarding the taxability of distributions from regulated investment companies.

Not only does the decision of the Minnesota Supreme Court not conflict with other state court decisions, the state court case most similar to this case is consistent with and supports the decision of the Minnesota Supreme Court. The Nebraska Supreme Court has rejected the very theory relied upon by Petitioners in this case. *Boersma v. Karnes*, 417 N.W.2d 341, 349 (Neb.), *appeal dismissed*, 488 U.S. 801 (1988). In *Boersma* one of the taxpayer's claims was that his social security benefits were, in part, interest on U.S. Government obligations and were therefore partially exempted from Nebraska income taxation by 31 U.S.C. § 3124(a) (1988). Similar to Petitioners in this case, the taxpayer in *Boersma* based this argument on the fact that the Old-Age and Survivors Insurance Trust Fund invests in interest bearing obligations of the United States. *Id.*, 417 N.W.2d at 349.[6]

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[6] The investment provisions for the Old-Age Fund in 42 U.S.C. § 401(d), (e) and (f) (1988) are strikingly similar to those for the Civil Service Retirement and Disability Fund in 5 U.S.C. § 8348(c), (d) and (e) (1988).

The Nebraska Supreme Court said that it did not know if plaintiffs' accurately stated how the laws of the United States operate, but held that in any event "the Nebraska income tax in this case does not operate as a tax on the interest generated by any U.S. financial security or obligation, but operates on moneys received, in the nature of retirement annuities . . . . Section 3124 does not prohibit the tax in question." *Boersma*, 417 N.W.2d at 349.

The *Boersma* decision thus rejected Petitioners' theory and is entirely consistent with the Minnesota Supreme Court's decision in this case.

II. THE MINNESOTA SUPREME COURT'S DECISION DOES NOT CONFLICT WITH THIS COURT'S DECISION IN *DAVIS V. MICHIGAN DEPARTMENT OF TREASURY*, 489 U.S. 803 (1989), BECAUSE MINNESOTA DOES NOT DISCRIMINATE AGAINST THE FEDERAL GOVERNMENT OR ITS EMPLOYEES.

In *Davis v. Michigan Department of Treasury*, 489 U.S. 803 (1989), this Court applied the prohibition against discriminatory taxes embodied in the modern constitutional doctrine of intergovernmental tax immunity and codified in 4 U.S.C. § 111 (1988). Michigan's income tax on retirement benefits received from the Fund was held invalid because Michigan discriminated against retired federal employees and in favor of retired state employees.

Petitioners assert that Minnesota taxes discriminate against Federal retirees. This assertion has no factual basis. Minnesota has never treated any portion of any

retiree's annuity as U.S. obligation interest. There is no basis to conclude that Minnesota discriminates against federal retirees.

Petitioners are merely speculating that *if* a case like *Keys v. Vermont Department of Taxes* (discussed in part I.B. of this brief) arose in Minnesota, the Minnesota courts would rule consistent with *Keys*. Speculation is not a proper ground on which to seek United States Supreme Court review.

Even if at some future time the Minnesota courts were to rule in a case like *Keys*, and even if they were to rule as the Vermont courts did, then the question would be whether the decision in that case is distinguishable from this one. Such a case would be distinguishable as shown in part I.B. of this brief.

CONCLUSION

The decision of the Minnesota Supreme Court in this case is correct under the governing legal principles. It does not deviate from or conflict with *American Bank & Trust Co. v. Dallas County*, 462 U.S. 855 (1983). Nor does it conflict with the decision of any state court applying 31 U.S.C. § 3124(a) (1988). Those state court decisions are distinguishable.

Nor does the Minnesota Court's decision conflict with *Davis v. Michigan Department of Treasury*, 489 U.S. 803 (1989). Minnesota's taxation of Petitioners retirement annuities is no different than its taxation of other retirement annuities.

Even if the Court were concerned that the issues presented might warrant further review, it would be prudent to allow additional courts the opportunity to analyze them. Then this Court's review, if necessary, would be fully informed by that additional scrutiny.

For the reasons presented in this brief, the Petition should be denied.

Respectfully submitted,

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CASE TYPE: DECLARATORY JUDGMENT

STATE OF MINNESOTA DISTRICT COURT

COUNTY OF HENNEPIN FOURTH JUDICIAL DISTRICT

Robert E. Meunier, Earl W. Miller, and Edward Garin,

Plaintiffs,

v.

Minnesota Department of Revenue, and Dorothy A, McClung, in her capacity as Minnesota Commissioner of Revenue,

Defendants.

Court File No. 91-000043

AFFIDAVIT OF PAUL A. ANTON

STATE OF MINNESOTA)
) ss.
COUNTY OF HENNEPIN)

PAUL A. ANTON states the following under oath:

1. I am President of Anton Financial Economics, Inc., an economic consulting firm. My business address is 256 First Avenue North, Suite 300, Minneapolis, Minnesota 55402. I was educated at the University of Minnesota. I hold a Bachelor of Arts degree (magna cum laude) from the University with majors in mathematics and economics. I subsequently completed coursework and preliminary oral exams for the Ph.D. in economics.

I have over twenty years experience as a practicing economist. From 1970 through 1979, I was a staff economist at the Federal Reserve Bank of Minneapolis. Following that, I joined First Bank System, a bank holding company located in Minneapolis. I worked for First Bank from 1979 through 1987, eventually holding the title of Director of Economics. My duties included analysis of financial markets, interest rate forecasting, and economic forecasting. I also consulted on a regular basis with portfolio manager and trust administrators in the company's trust department.

In 1987, I formed the firm of Anton Financial Economics, Inc. and have done various forms of economic consulting for both private-sector and public-sector entities. This consulting has included expert testimony in securities cases, economic advice to investment managers, and advising company officials about the investment of pension and profit-sharing accounts.

2. I have been asked to give my opinion on issues affecting the taxability of benefits of annuity payments made by the Civil Service Retirement and Disability Fund ("CSRDF") to individuals in the state of Minnesota. In preparing these comments I have relied upon information contained in the Annual Reports of the CSRDF dated September 30, 1986 and September 30, 1987 which were provided to me by the Minnesota Attorney General's Office and on my knowledge and background experience in economics and investment matters. The following are my opinions:

3. The imposition of Minnesota income taxes on annuity payments received from the CSRDF by retirees,

disabled persons, and survivors ("participants") does not increase the cost to the United States of borrowing money nor does it diminish in any degree the market value or investment attractiveness of United States government obligations. The CSRDF is required to invest its assets in U.S. government obligations and must continue to do so without regard for taxation of participants.

4. CSRDF is a defined benefit plan, meaning that the participants are entitled to a certain defined stream of benefit payments which does not depend on the amount or sources of investment income of the CSRDF. The CSRDF may pay participants from funds which are actually being received as contributions by other participants.

5. There is no sense in which participants in the plan are owners of U.S. government securities or may be said to be receiving interest on U.S. government securities. They are receiving specified payments from CSRDF which may invest idle funds in either taxable or nontaxable U.S. government obligations.

6. The CSRDF is not designed as a "pass-through" entity or partnership in which ownership and rights of ownership of the assets are passed to the participants or partners. If the CSRDF were designed in this way participants would be at risk in that the level of the monthly benefit payments would be subject to fluctuations dictated by the investment performance of CSRDF.

7. It is not possible to determine the share of the CSRDF which is attributed to any one individual.

8. The benefit payments being made to participants in the CSRDF arise out of, and are in consideration for,

prior employment with the federal government. In both the public and private sectors of the economy, the opportunity to participate in such plans is considered an important element of a compensation package and a powerful inducement to join or remain with a given employer.

END OF AFFIDAVIT.

/s/ Paul A. Anton
PAUL A. ANTON

Subscribed and sworn to before
me on February 28, 1992.

/s/ Kimberly S. Nohe
Notary Public
[seal]

Case Type: Declaratory Judgment

STATE OF MINNESOTA DISTRICT COURT

COUNTY OF HENNEPIN FOURTH JUDICIAL DISTRICT

Robert E. Meunier, Earl W. Miller, Edward Garin, and Minnesota Federation of Chapters, National Association of Retired Federal Employees, an unincorporated association,
Plaintiffs,

Court File No. MC-91-00043

AFFIDAVIT OF HOWARD J. BICKER

v.

Minnesota Department of Revenue, and Dorothy A. McClung, in her capacity as Minnesota Commissioner of Revenue,

Defendants.

STATE OF MINNESOTA)
) ss.
COUNTY OF RAMSEY)

HOWARD J. BICKER states the following under oath:

1. I am the Executive Director of the Minnesota State Board of Investment, having served in this capacity since December, 1982. I first joined the State Board of Investment in 1971 and before becoming its Executive Director, served in various capacities including Senior Portfolio Manager, Assistant Executive Director, and Acting Executive Director.

The Minnesota State Board of Investment presently invests more than $17 billion of which about $15 billion are pension plan assets of the three statewide public employee pension plans and about $2 billion are state moneys in the form of various cash and trust fund accounts.

I have a bachelor's degree from Winona State University and an M.B.A. in Finance from the College of St. Thomas in St. Paul.

2. I have reviewed the annual reports for fiscal years ending 9/30/86 and 9/30/87 of the Civil Service Retirement and Disability Fund (the "Fund"). Based upon those reports, and upon my professional experience and training, I state the following professional opinions:

a. The Fund is a defined benefit plan providing retirement, disability and survivor benefits. The Fund is obligated to pay these benefits without regard to whether moneys come from investment income or contributions from various sources, current or past.

b. Such benefits are typically provided by an employer as an inducement to persons to become and remain employees.

c. Monthly payments (annuity payments) received from the Fund by a retired federal employee are in consideration of services previously renderd by the employee to the federal government.

d. It is inappropriate to characterize any portion of the monthly payments received by annuitants from the Fund as interest on United States government obligations.

e. It is impracticable to determine the amount of any individual's interest or share in the Fund.

END OF AFFIDAVIT.

/s/ Howard Bicker
HOWARD J. BICKER

Subscribed and sworn to before
me on February 27, 1992.

/s/ Harriet Balian
Notary Public
[seal]